

# Final Withholding Taxation of Portfolio Dividends in the Internal Market

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<b>Tiivistelmä□□ Referat – Abstract</b>  <p>Tax withholding refers to a procedure for charging taxes, where the payer of the income (withholding agent) charges the tax from the income payable to the income recipient and transfers the charged amount to the tax authorities on behalf of the income recipient. Final withholding tax refers to a tax, where the tax charged by the withholding agent is the taxpayer's final tax burden in the source State. Consequently, the procedure involves no regular subsequent steps to withholding. Final withholding tax is charged simultaneously with the payment of the income. The tax is levied on gross income.</p> <p>Final withholding taxes are widely used in taxation of portfolio dividends in the source State, when the dividend recipient is not a resident of that State. Most of the Member States of the European Union apply final withholding also in intra-EU settings, where both the source State of the portfolio dividends and the State of residence of the taxpayer are EU States. The popularity of final withholding taxes is explained with their effectiveness in ensuring that the source State can collect taxes on dividends received by nonresident taxpayers, who may have no other connection with the source State. Furthermore, final withholding taxes are easily administrable.</p> <p>States do not commonly use final withholding taxes for taxation of portfolio dividends in domestic settings, where the dividend recipient is resident in the source State of the dividends, because final withholding taxes are not compatible with taxation of net income. Consequently, States apply different tax systems on resident and nonresident dividend recipients. This may violate the fundamental freedoms, if the source State subjects nonresident taxpayers to less beneficial treatment than comparable resident taxpayers. The Court of Justice of the European Union has held final withholding taxes admissible in principle, but Member States have been compelled to extend many beneficial tax rules to apply also, if a nonresident taxpayer receives the dividends.</p> <p>What follows from the case law of the Court of Justice of the European Union is, firstly, that the differences in the taxation of resident and nonresident taxpayers in the source State are reduced. Secondly, the nonresident taxpayer is often required to resort to the refund procedure before it receives as beneficial a treatment as it should under the fundamental freedoms. The refund procedure eliminates most of the benefits of final withholding taxes: it is a lengthy and expensive procedure, and the nonresident taxpayer is most likely required to resort to external assistance. Application of relief at source and streamlining the refund procedure would alleviate the problems that currently plague the refund procedure.</p>		
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## Abbreviations

AG	Attorney General
Art.	Article
ATAD	Anti-Tax Avoidance Directive
BEPS	Base Erosion and Profit Shifting
C-	Case Number Court of Justice of the European Union
CFC	Controlled Foreign Corporation
CIV	Collective Investment Vehicle
CJEU	Court of Justice of the European Union
CMU	Capital Markets Union
COM	Document of the European Commission
CRS	Common Reporting Standard
DAC	Directive on Administrative Cooperation in Tax Matters
EEA	European Economic Area
EFTA	European Free Trade Association
EU	European Union
FATCA	Foreign Account Tax Compliance Act
MAATM Convention	Convention on Mutual Administrative Assistance in Tax Matters
MC	Model Convention
OECD	Organization for Economic Cooperation and Development
OJ	Official Journal of the European Union
PSD	Parent-Subsidiary Directive
RAD	Recovery Assistance Directive
SWD	Staff Working Document
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
VAT	Value Added Tax

# 1 Introduction

## 1.1 Background

Withholding taxes are an old and tried way for States to ensure the taxation of outbound income payments efficiently.<sup>1</sup> They are widely used both in domestic and in cross-border settings and, for example, every EU State applies at least some type of tax withholding system.<sup>2</sup> Taxation of cross-border portfolio dividends is prevalently carried out with final withholding taxes, where the tax is collected by the dividend distributor (*withholding agent*) and the tax is not subject to any subsequent assessment.<sup>3</sup> Final withholding taxes ensure effective tax collection from nonresident taxpayers in the source State without excessive administrative burden, because the tax is collected before the dividends ‘leave’ the jurisdictional reach of the source State. However, the disadvantage of final withholding taxation is that the expenses of the taxpayer cannot be easily deducted from the taxable income.<sup>4</sup> In domestic settings, where States have no jurisdictional constraints with the enforcement of their tax legislation,<sup>5</sup> States usually resort to provisional withholding or advance taxes in taxation of dividend income in order to take the taxpayer’s ability to pay taxes into account.<sup>6</sup>

The Treaty on the Functioning of the European Union (‘TFEU’) prohibits discrimination, i.e. applying different rules to comparable situations or applying the same rules to different situations.<sup>7</sup> The fundamental freedoms prescribe that, as a rule, cross-border activity shall not be hindered by treating cross-border settings less beneficially than comparable domestic settings.<sup>8</sup> Therefore,

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<sup>1</sup> See *infra* ch. 3.1.1.

<sup>2</sup> See the respective chapters in PwC 2018. *Withholding tax* refers to a tax that is collected through the collection mechanism of ‘withholding’, where the payer of the income withholds the tax from the income payable, whereas *tax withholding* refers to the act of tax collection by withholding. Tax withholding is most commonly applied in taxation of employment income and in taxation of outbound passive income. Within the EU Member States, the practices also vary, as some States subject most of income types to withholding (e.g. Finland), whereas others utilize withholding only exceptionally (e.g. Hungary). However, it seems more common that tax withholding is applied rather widely than that it is applied only exceptionally. See Lee & Yoon 2018, 15–16 and 22; Kolozs & Kőszegi 2018, 277 and 281; PwC 2018.

<sup>3</sup> See Lee & Yoon 2018, 20 and 26.

<sup>4</sup> See further *infra* ch. 3.

<sup>5</sup> Cf. Rohatgi 2007, 14.

<sup>6</sup> See *infra* ch. 4.1.

<sup>7</sup> See e.g. C-513/04, *Kerckhaert and Morres*, para. 19 and the cited case law. See also Helminen 2018a, 67–69.

<sup>8</sup> Besides the general prohibition of discrimination in Art. 18 TFEU, the TFEU also prohibits restrictions to the fundamental freedoms. In direct tax cases, however, the fundamental freedoms are interpreted so that they prohibit discrimination in a similar manner as Art. 18 TFEU, but not non-discriminatory restrictions. Discriminative taxation may be justified under overriding reason of public interest. See *infra* ch. 2.3.2.2 and Helminen 2018a, 74.

applying different tax rules on resident and nonresident dividend recipients may be precluded by the TFEU. On the other hand, the application of identical rules both on resident and on nonresident taxpayers may also be precluded by the TFEU, if the rules are *de facto* less beneficial to nonresidents that are essentially similar to residents.<sup>9</sup> The Court of Justice of the European Union (‘CJEU’) has in many occasions evaluated the compatibility of domestic dividend taxation practices with the fundamental freedoms, and the Member States have been compelled to alter their tax laws where they infringe the fundamental freedoms. This development has made the national tax laws of Member States more ‘internal market friendly’<sup>10</sup> when taken individually, but the CJEU is not able to tackle impediments that derive from the non-harmonisation of tax laws.<sup>11</sup> As a consequence of the lack of harmonisation of portfolio dividend taxation, an investor active in the EU does not see an “area without internal frontiers”<sup>12</sup> but 28 separate taxing jurisdictions, each of which has their own rules and compliance requirements.<sup>13</sup>

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<sup>9</sup> See e.g. C-580/15, *Van der Weegen and Others*, para. 29. See also Zalasinski 2017, 533–543; Helminen 2018a, 75.

<sup>10</sup> I.e. more compatible with the fundamental freedoms.

<sup>11</sup> Cf. Terra & Wattel 2019, 47–48.

<sup>12</sup> Art. 26(2) TFEU.

<sup>13</sup> For example, an investor active in the EU has to complete up to 56 separate national forms in order to receive withholding tax relief. See Commission 2017a, 10.



## 1.2 Subject of the Study, Structure and Methodology

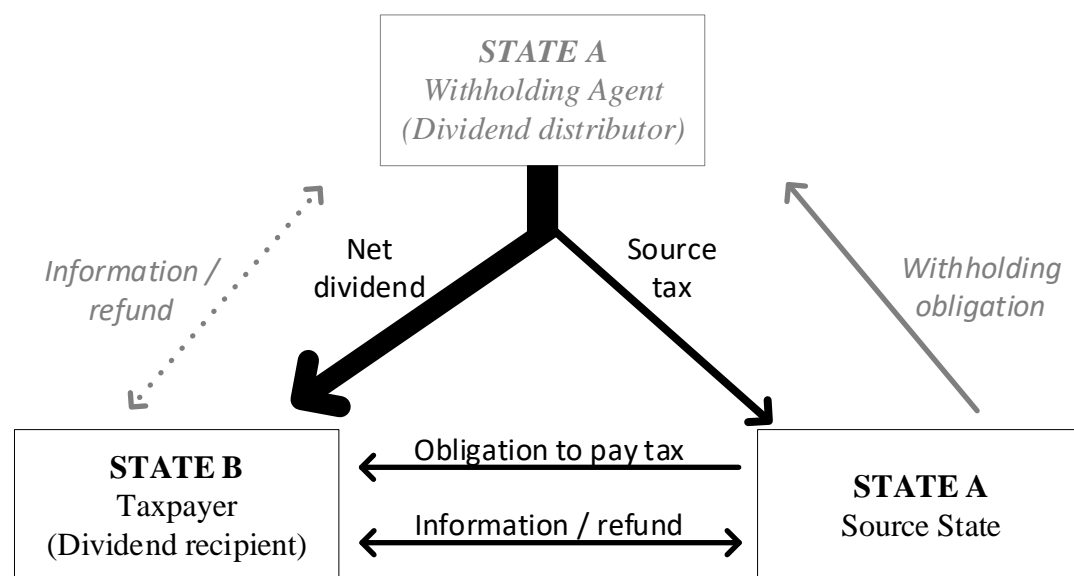


Figure 1 – A simplification of withholding procedure.

The subject of this study is tax withholding as a tax collection method in the internal market. As illustrated in *Figure 1*, in withholding procedure, the withholding agent charges the tax from the taxpayer's income on behalf of the State and transfers it to the State on behalf of the taxpayer. The focus is on the relationship of the source State and the taxpayer: what benefits and disadvantages final withholding taxation of portfolio dividends has from the perspective of a nonresident taxpayer, resident in one Member State, and the source State of the dividends, which is another Member State?

Withholding taxes have been subject to stable case law of the CJEU since the *Gerritse*<sup>14</sup> case in 2003.<sup>15</sup> The case law has been constantly evolving since then and the CJEU has still been issuing preliminary rulings in withholding tax cases.<sup>16</sup> The case law has been subject to extensive coverage in academic literature.<sup>17</sup> However, less attention has been paid to withholding taxes in itself. Yet, it is important to understand the inherent qualities of withholding taxes in order to better

<sup>14</sup> C-234/01, *Gerritse*.

<sup>15</sup> See Simader 2013, 4.

<sup>16</sup> To name some recent cases, see e.g. C-18/15, *Brisal*; Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg 1 and Others v Skatteministeriet*; Joined Cases C-116/16 and C-117/16, *Skatteministeriet v T Danmark and Y Denmark Aps*; Joined Cases C-504/16 and C-613/16, *Deister Holding and Juhler Holding*; C-575/17, *Sofina*.

<sup>17</sup> For example, the main sources of this study contain extensive coverage and analysis of the CJEU's case law. See Simader 2013; Helminen 2018a; Lang et al. 2018; Terra & Wattel 2019. Furthermore, countless articles have been published in tax periodicals, such as *EC Tax Review*, *European Taxation* and *Intertax*, to name a few.

understand, why they consistently bring up issues to be solved in the CJEU. Lastly, it is worthwhile taking a look if there were a way to enhance the efficiency of the existing system of levying final withholding taxes on portfolio dividends and, in case of overtaxation, subsequently refunding the excess amount.<sup>18</sup> Therefore, this study answers the following research questions:

- (i) What are the benefits and disadvantages of final dividend withholding taxation in cross-border settings in the internal market?
- (ii) What is the current tax treatment of outbound portfolio dividends in the internal market?
- (iii) How could the prevailing system for taxation of cross-border portfolio dividends be refined?

This study combines theoretical and legalistic examination. The second chapter introduces the framework of both international and EU tax law that affects the taxation of cross-border portfolio dividends, with the approach being predominantly legalistic. In the third chapter, the benefits and disadvantages of final dividend withholding taxes in cross-border settings in the internal market are analysed from a theoretical standpoint against the desirable qualities of an income tax system. The fourth chapter provides an outlook to the relevant case law of the CJEU and concludes with the admissibility of final withholding taxes from the EU law perspective. The analysis is legalistic, but a comparative approach is also utilized to provide an overview of the current practices that Member States apply in taxation of domestic portfolio dividends. Finally, the fifth chapter includes a brief *de lege ferenda* outlook concerning the possibilities for refining the existing system. The sixth chapter concludes.

### 1.3 Limitations and Assumptions

Source taxation of portfolio dividends is a broad topic and even withholding taxes could be studied from multiple perspectives.<sup>19</sup> However, for the purposes of this study, tax withholding is

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<sup>18</sup> Positive harmonisation with directives or regulations would probably be the most efficient way to eliminate impediments that source State withholding taxes cause to the functioning of the internal market. However, Member States are generally reluctant to give up their sovereignty in direct tax matters. Art. 115 TFEU, containing the authorization to issue directives concerning direct taxation, requires unanimity, which is why positive harmonisation has been – and still is – difficult to attain. Therefore, possibilities brought by positive harmonisation are not discussed.

<sup>19</sup> For example, source State withholding taxation can be viewed from the perspective of double taxation and allocation of taxing rights between the source State and the State of residence. Furthermore, the administrative burden induced to the withholding agent or the relative ease of administering a tax withholding system for the tax authorities, as well as tax avoidance and evasion perspectives, would all be worthwhile studying. The popularity of Collective Investment Vehicles ('CIV') has also raised some questions specific to that industry in the recent decades. With respect to CIVs, see e.g. ICG Report 2009; Lee & Yoon 2018, 11–12.

understood as presented in *Figure 1*. The most important initial limitations are the exclusion of comparability analysis, which allows for disregarding the person type of the taxpayer, exclusion of the relationship of the withholding agent and the source State, and exclusion of the taxpayer's tax treatment in the State of residence. These limitations and assumptions are justified below.

Firstly, the source State may apply different rules on resident and nonresident taxpayers depending on whether the taxpayer is a corporate entity or other legal entity, or a natural person.<sup>20</sup> Tax withholding *per se* is, however, a similar procedure regardless of the taxpayer. Therefore, the person of the taxpayer is not relevant for analysing withholding taxes. Secondly, this study focuses on the taxation in the source State, and the taxation in the taxpayer's State of residence is largely disregarded. The source State usually applies final withholding taxation on taxing portfolio dividends received by nonresident taxpayers. Consequently, the benefits and disadvantages also arise due to the actions of the source State and, therefore, tax treatment in the taxpayer's State of residence need not be extensively discussed. However, it is noted that discriminative tax treatment in the source State may be allowed, if the taxpayer's State of residence eliminates the disadvantage caused to the taxpayer by the source State's taxation, provided that this elimination is based on a tax treaty obligation.<sup>21</sup> Thirdly, the withholding obligation naturally increases the administrative burden of the withholding agent, but this issue is not considered separately. Similarly, the relationship of the State and the withholding agent is not subject to the study. In general, it will be assumed that the withholding agent may require the taxpayer to provide some information, such as the place of tax residence, legal form, and relationship with the payer of the income. Provided that this information meets some adequate standard of reliability, the withholding agent may apply a correct withholding tax rate set in, for example, the domestic legislation or a tax treaty. The withholding agent typically has some way to incentivize the taxpayer to provide the information in a timely manner, such as the possibility to withhold the tax at the highest rate available if the taxpayer is not cooperative. However, the withholding agent cannot be expected to perform extensive inquiries in order to verify the information or acquire information in case of non-

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<sup>20</sup> For example, Member States may not levy tax on intercompany cross-border profit distributions from direct investments due to the Parent-Subsidiary Directive. However, the directive does not prohibit taxation, if the recipient of the income is a natural person.

<sup>21</sup> See *infra* ch. 2.3.2.2.

cooperation of the taxpayer. It is also assumed that the State preserves the cooperation and compliance of the withholding agent with proper supervision and sanctions.<sup>22</sup>

Furthermore, the technical or juridical execution of withholding is not discussed.<sup>23</sup> It is adequate to assume that the payer of the income is the person committing the withholding and, therefore, the withholding procedure involves the three bodies as illustrated in *Figure 1*, namely the source State, the taxpayer and the withholding agent. Similarly, the technical nuances of the refund procedure are largely omitted.<sup>24</sup> With regard to the taxpaying relationship between the State and the taxpayer, it is not relevant, which body technically pays the refund or to whom the taxpayer delivers required information. For simplicity, it is assumed that subsequent to withholding, the taxpayer deals directly with the authorities of the source State and the withholding agent is not involved anymore. However, prior to withholding, the taxpayer may provide information directly to the withholding agent, as described above. Finally, it is assumed that the withholding agent is resident in the source State and, therefore, the source State can apply its jurisdiction to the withholding agent without restrictions.<sup>25</sup>

## 1.4 Terminology

In this study, the term *withholding tax* refers to a tax collection system, where the tax is collected through withholding. The term *tax withholding* refers to the act where the withholding agent deducts the tax from the income payable to the taxpayer. The terms *taxpayer*, *income recipient* and *dividend recipient* are used interchangeably. They refer to the person who receives the portfolio dividends and is liable to pay taxes on those dividends in the source State. The terms *withholding*

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<sup>22</sup> For example, the withholding agent may be liable to pay the tax in case of failure to withhold or it may even be subject to criminal penalties in case of intentional or fraudulent behaviour. See Lee & Yoon 2018, 19–20 and 27.

<sup>23</sup> Generally, it is not necessary that the person making the payment in juridical sense (e.g. the dividend-distributing company) is the same as the person technically making the payment and committing the withholding. For example in Austria, capital gains from the sale of a private real estate is usually collected by way of ‘withholding’, where the lawyer or notary public being in charge of the transaction self-assesses and transfers the tax to the tax authorities. See Daurer & Jann 2018, 69. In Belgium, Belgian-resident financial intermediaries involved in payment of, e.g., foreign-sourced dividends usually collect the withholding tax. See Delacroix 2018, 89 and 92.

<sup>24</sup> For example, some States may require the taxpayer to submit information to the withholding agent for refund, whereas other States require the information to be submitted to them directly. In some instances, the withholding agent may also make the refund payment instead of the source State. See Lee & Yoon 2018, 27. For example in South Africa, the nonresident taxpayer may claim for refund from the withholding agent and, if the claim is admissible, the withholding agent must pay the refund to the nonresident taxpayer and recover it from the South African tax authorities. See Koole 2018, 623.

<sup>25</sup> In some instances, States may exceed the withholding obligation to nonresident payers. These situations of extraterritorial withholding are, nevertheless, not common in dividend taxation and will not be discussed further. See Lee & Yoon 2018, 25–26.

*agent, dividend distributor and payer of the income* are similarly used interchangeably. The withholding agent is the person who distributes the dividends to the taxpayer and is obliged to deduct the tax from the income payable to the taxpayer. In this study, the company distributing the dividends is the withholding agent.<sup>26</sup>

The term *resident taxpayer* or simply *resident* refers to any person who is liable to tax in the *State of residence* under the laws of that State, for example, due to domicile, residence or place of management. The term *nonresident taxpayer* or simply *nonresident* refers to any person who is liable to tax in the *source State* only on income that has its source in that State or because of capital situated in that State. The terms *State* and *tax authorities* are often used as substitutes of each other, unless the context allows for a different interpretation.

The term *direct investment* refers to any investment that is made in a company with the purpose of establishing or maintaining lasting and direct links between the investor and the company and which allows the investor to participate in the management of the company or in its control.<sup>27</sup> Generally, direct investment relationship requires the investor having a substantial holding in the capital or the voting rights of the company.<sup>28</sup> A holding of 10 per cent or more is usually considered to form a direct investment relationship.<sup>29</sup> The term *portfolio investment* refers to an investment that does not qualify as a direct investment. *Direct investment dividends* and *portfolio dividends* refer to dividends received from a company in which the dividend recipient has made a direct investment or a portfolio investment, respectively. The definition of *dividend* is not linchpin to this study, as the topic is concentrated on the tax collection system, not the tax subject to collection.<sup>30</sup>

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<sup>26</sup> Naturally, the withholding agent could also be e.g. the custodian bank or some other financial entity.

<sup>27</sup> C-157/05, *Holböck*, paras. 32–25; C-685/16, *EV*, paras. 67–68.

<sup>28</sup> Helminen 2010a, 14.

<sup>29</sup> The limit varies in different frameworks. For example, the Parent-Subsidiary Directive sets the limit for the participation exemption to a holding of 10 per cent (Art. 3(1)(a) PSD). The OECD MC sets the limit to 25 per cent (Art. 10(2)(a) OECD MC), and the limit varies in actual tax treaties. Participation exemption is generally applied only with regard to intercompany dividends (e.g. in the OECD MC; PSD also applies only between companies). Therefore, the term direct investment is often used only in intercompany investments, and thus all investments made by natural persons are portfolio investments. See e.g. Helminen 2010a, 14; Helminen 2018b, ch. 9. On the other hand, the CJEU has not required the investor to be a company for Treaty interpretation purposes. See e.g. C-157/05, *Holböck*, paras. 32–25; C-685/16, *EV*, paras. 67–68. The difference in the approaches is not relevant for this study.

<sup>30</sup> On tax law definition of dividend, see generally e.g. Helminen 2010a. Generally, dividend distribution refers to a transaction, where a corporate entity distributes its profits to its owners without expecting to receive anything in return. See Helminen 2010a, 1.

In the parlance generally used in this study, the dividend distributor is considered to be a resident in the source State, which is a Member State, and the taxpayer is considered to be a resident in another Member State. Consequently, the taxpayer is a nonresident in the source State.

## 1.5 Materials

The main sources in the field of EU tax law are *European Tax Law* by Terra & Wattel,<sup>31</sup> *EU-vero-oikeus* by Marjaana Helminen<sup>32</sup> and *Introduction to European Tax Law on Direct Taxation*, edited by Lang et al.<sup>33</sup> Roy Rohatgi's *Basic International Taxation*<sup>34</sup> and Marjaana Helminen's *Kansainvälinen verotus*<sup>35</sup> have been valuable sources with regard to the general concepts of international taxation. Janne Juusela's doctoral thesis *Kansainväliset sijoitukset ja verotuksen tehokkuus*<sup>36</sup> has provided important insights to the theoretical background and principles of international tax law. An invaluable source on withholding taxation is the recent *Cahier* on the second subject of the International Fiscal Association's 2018 Seoul Congress, *Withholding tax in era of BEPS, CIVs and digital economy*.<sup>37</sup> Sources focusing on the act of tax withholding in itself have been scarcer, but especially articles published in U.S. university law reviews by Piroška Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*,<sup>38</sup> and Leandra Lederman, *Statutory Speed Bumps: The Roles Third Parties Play in Tax Compliance*,<sup>39</sup> have been helpful. Furthermore, multiple other articles published in numerous tax journals and periodicals as well as law reviews of European and American background have also been greatly influential to this study.

Lastly, Karin Simader's doctoral thesis *Withholding Taxes and the Fundamental Freedoms*,<sup>40</sup> published in 2013, has been a valuable source and provided many insights. Although Dr. Simader's

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<sup>31</sup> Terra & Wattel 2019. The seventh edition, printed in 2019, is actually edited by Peter J. Wattel, Otto Marres and Hein Vermeulen and is essentially an updated version with multiple distinguished authors of the other half of the Terra & Wattel's 2012 *European Tax Law* (general topics and direct taxation). The book still carries the name "Terra/Wattel" and due to the book's established nature as a seminal work in European tax law, it is still referred to as 'Terra & Wattel 2019'.

<sup>32</sup> Helminen 2018a.

<sup>33</sup> Lang et al. 2018.

<sup>34</sup> Rohatgi 2007.

<sup>35</sup> Helminen 2018b.

<sup>36</sup> Juusela 1998.

<sup>37</sup> IFA 2018.

<sup>38</sup> Soos 1990.

<sup>39</sup> Lederman 2007.

<sup>40</sup> Simader 2013.

doctoral thesis resembles closely to the subject of this study, the approach is rather different. Simader's study is a rather straightforward review of withholding taxation in the light of the CJEU's legal praxis.<sup>41</sup> By contrast, this study focuses more on the qualities of tax withholding *per se*. Furthermore, after the publication of the Simader's study, development has taken place especially in the field of mutual assistance in direct tax matters, information exchange and anti-tax avoidance.

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<sup>41</sup> See Simader 2013, xi.

## 2 Rules Governing the Taxation of Outbound Portfolio Dividends in the Internal Market

### 2.1 Introduction

The rules governing taxation of cross-border portfolio dividends in the European Union are, in practice, rules of international tax law applied in a way that is compatible with the EU law. The starting point of international tax law (i.e. taxation of resident taxpayers on their worldwide income or wealth and taxation of nonresidents on their domestic income or wealth) is fundamentally different from the concept of internal market, the aim of which is, in essence, to create ‘one single jurisdiction’ and to abolish the difference between residents and nonresidents.<sup>42</sup> Taxation of dividends has mostly remained within the competence of the Member States, therefore leading to a situation where there is no ‘European tax regime’ but 28 separate tax regimes that coexist and that are in interplay under the norms of international tax law. However, Member States must apply their domestic tax laws in line with the EU law.<sup>43</sup> Therefore, in principle, Member States may not treat cross-border dividends less beneficially than domestic dividends in comparable settings.<sup>44</sup> Less beneficial treatment of cross-border dividends is not always prohibited by the EU law, but the situations where such treatment is allowed are getting scarcer, as the mutual assistance in direct tax matters has increasingly intensified.<sup>45</sup>

Resident taxpayers are often taxed on their global income and global income tax regimes are predominantly based on a subjective ability to pay.<sup>46</sup> For companies, this often means that all business expenses are deductible. For natural persons, the expenses related to acquiring the income are usually deductible, and furthermore, the taxpayer may be allowed to deduct different personal expenses (such as alimony payments) or may be allowed for some personal deduction due to family or personal circumstances (for example, spouse allowance). Nonresident taxpayers are typically

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<sup>42</sup> Terra & Wattel 2019, 611.

<sup>43</sup> See e.g. C-279/93, *Schumacker*, para. 21; C-35/98, *Verkooijen*, para. 32; C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, para. 36; C-498/10, *X NV*, para. 18.

<sup>44</sup> Treating cross-border settings less beneficially than comparable domestic settings amounts to discrimination, which is, in principle, prohibited by the Treaties. See Lazarov 2018, 73.

<sup>45</sup> Cf. Helminen 2018a, 135. Less beneficial treatment may be justified by an overriding reason of public interest. Furthermore, the justified measure must be proportionate, i.e. suitable and necessary for achieving its objective. See *infra* ch. 2.3.2.2. See also Helminen 2018a, 132–133.

<sup>46</sup> Simader 2013, 34.



taxed only on the specific piece of income that is derived from the source State. Generally, the source State does not take into account the nonresident taxpayer's personal circumstances, which is logical, as the source State only 'sees' the one isolated transaction that derives from that State and is not in a good position to assess the taxpayer's global income and expenses.<sup>47</sup>

## 2.2 International Tax Law, Connecting Factors and Tax Treaties

International tax law is a part of international law that deals with taxation in cross-border settings, that is, situations where two or more States claim to have power to tax the same income, wealth or person. The principles of international tax law draw from tax treaties, domestic tax laws and customary practices of States.<sup>48</sup> International tax law does not traditionally consist of supranational norms that apply equally to all States, but rather of States' domestic tax laws that apply in cross-border settings, together with bilateral and multilateral tax treaties.<sup>49</sup> With respect to the EU States, the EU law is a further source of international tax law. The superiority of the EU law over domestic legislation of Member States obligates Member States also in the field of direct taxation and, therefore, Member States must apply international tax law in a way that does not infringe the EU law.<sup>50</sup> The EU law is also superior to the tax treaties, and tax treaties are, as international treaties, superior to domestic legislation.<sup>51</sup>

The taxation of cross-border dividends is ultimately based on the domestic tax laws of States. Tax treaties cannot expand a State's taxing rights beyond what it is under that State's domestic tax legislation.<sup>52</sup> Domestic law alone sets the *connecting factors* that define who can be taxed by the

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<sup>47</sup> Lee & Yoon 2018, 26.

<sup>48</sup> Avi-Yonah 2004, 483–501; Rohatgi 2007, 1 and 14. There are differing views between authors whether international tax law is a branch of international law, although differing from generally applicable international law in some details, or whether it should be kept separate from generally applicable international law due to e.g. lack of collision norms. For example, Avi-Yonah 2004, 483–501 and Rohatgi 2007, 13–14, place international tax law as a part of international law, whereas Helminen 2018b, ch. 3, argues that international tax law should be kept more separate from generally applicable international law.

<sup>49</sup> Helminen 2018b, ch. 3.

<sup>50</sup> Helminen 2018a, 43–44; Helminen 2018b, ch. 3.

<sup>51</sup> See further e.g. Helminen 2010a, 32 and 37–39.

<sup>52</sup> This principle is also known as the *golden rule of tax treaty law* or as the *negative effect of tax treaties*. See Vapaavuori 1991, 40; Helminen 2010a, 32. According to Helminen, some exceptional tax treaty provisions, such as Art. 25 of the OECD MC, may sometimes be interpreted to expand the power to tax of the contracting States beyond to the scope of their domestic tax legislation. See Helminen 2010a, 32. Furthermore, the EU law may impose Member States an obligation to levy tax. This is most apparent with respect to the VAT. The new hybrid mismatch rules introduced in *ATAD II* (Council Directive 2017/952) may also require Member States to extend their fiscal jurisdiction by obligating a Member State to include income into tax base in certain cases. However, whether the obligation to tax in these cases stems directly from the EU law itself or from domestic legislation of Member States eventually depends

State (i.e. who is a *tax subject* in that State) and what can be taxed in the State (i.e. what is a *tax object*, or taxable event, in that State).<sup>53</sup> The internationally prevailing concept is that the residence State exercises unlimited taxation rights on the worldwide income of its residents (*residence principle*) and the source State exercises limited taxation rights on nonresident income recipients, who derive income from economic activities within its territory (*source principle* or *territoriality principle*).<sup>54</sup> The EU law does not dictate acceptable connecting factors upon which Member States should base their taxation, and different connecting factors may be applied on residents and nonresidents.<sup>55</sup>

States may agree with other States in bilateral or multilateral tax treaties that they limit the utilization of their power to tax in order to, for example, avoid juridical double taxation. In other words, one of the main functions of tax treaties is to allocate the taxing rights between the source State and the State of residence. Tax treaties use the *classification and assignment* method as the basis for income allocation between the source State and the State of residence, where the taxing rights are allocated on an item-by-item basis as determined appropriate with the help of the *economic allegiance*<sup>56</sup> analysis.<sup>57</sup> Generally, the source State has a primary right to tax income that

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on the constitutional relationship of the EU law and the domestic laws of each Member State. Regarding the hybrid mismatch rule, see e.g. Govind & Zolles 2018, 235–240; Helminen 2018a, 240–246; Terra & Wattel 2019, 522–526.

<sup>53</sup> See e.g. Rohatgi 2007, 196; Helminen 2010a, 32.

<sup>54</sup> Rohatgi 2007, 15 and 22. States apply different connecting factors for defining when a taxpayer is a resident taxpayer, or *generally tax liable*, in that State. These connecting factors usually relate to the taxpayer's person, such as domicile or citizenship (natural persons) and place of incorporation or place of effective management (legal persons). For example, Finland considers domestic entities and persons, who have resided in Finland during the tax year, as resident taxpayers (Sec. 9(1) Tuloverolaki 1535/1992).

Taxation of nonresidents (i.e. source taxation) is usually based on economic connecting factors, i.e. income must have an economic attachment to a State in order for that State to be able to exercise its taxing rights as the source State. Source taxation is usually justified with the *benefits principle*, the rationale being that the source State has offered the nonresident taxpayer an opportunity to generate income in that State. See e.g. Avi-Yonah 2014, ch. 3.2; Helminen 2018b, ch. 3; Terra & Wattel 2019, 612. The principle is not uncontested. For differing views, see e.g. Kaufman 1998, 183–188; Shay, Fleming & Peroni 2002, 89–93. For example, Finnish income tax act includes a non-exhaustive list of situations, where Finland considers income being of Finnish source (Sec. 10 Tuloverolaki 1535/1992). See also Nykänen 2015, 124–198.

<sup>55</sup> Terra & Wattel 2019, 614–616. For example, in Case C-96/08, *CIBA*, para. 37, the CJEU expressly recognized that “the Member State in which the seat of the undertaking is located enjoys, in the absence of a double taxation convention, the right to tax that undertaking overall”. In Case C-311/08, *SGI*, para. 60, the CJEU explicitly accepted source State taxation, stating that the balanced allocation of taxing rights justification “may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory”. Territoriality was accepted in Case C-414/06, *Lidl Belgium*, para. 31.

<sup>56</sup> As opposed to, for example, political allegiance (citizenship), temporary residence, domicile (permanent residence) or *situs* (location of the property). See Seligman 1895, 108–110; League of Nations 1923, 19–20.

<sup>57</sup> Rosenbloom & Langbein 1981, 366. The modern tax treaties have their roots in the first bilateral tax treaties concluded in and after the late 19<sup>th</sup> century. The first tax treaty addressing international double taxation was concluded

is earned within its jurisdiction, and the State of residence has only a secondary (residual) taxing right (*source State entitlement principle*).<sup>58</sup> The State of residence is usually required to eliminate double taxation either with the credit or the exemption method. In other words, the source State's right to tax is superior to the right to tax of the State of residence, but it is strictly geographically limited.<sup>59</sup>

## 2.3 EU Tax Law

### 2.3.1 Internal Market

One of the European Union's core priorities is establishing and maintaining an internal market,<sup>60</sup> which is, in essence, an area without internal frontiers.<sup>61</sup> Taxation is, obviously, capable of creating such 'internal frontiers' and it effectively does so as long as the Member States maintain their tax sovereignty and do not harmonise their tax systems. However, the objectives of the internal market are not the solitary aspects that must be considered in intra-EU economic relations. The tax sovereignty of Member States is among the aspects that cannot be ignored.<sup>62</sup> Therefore, the CJEU has consistently stated that at this stage of development, the EU law cannot eliminate tax disadvantages caused by the parallel exercise of taxing power.<sup>63</sup> Member States may apply their domestic tax legislation as they please, as long as they do not apply tax rules that are discriminative, either directly or indirectly, unless the discrimination is justified and proportionate.<sup>64</sup>

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between Prussia and Saxony in 1869, although it expired automatically in 1870, when the German federal laws addressing double taxation were introduced. The first actual income tax treaty expressly concerned with the prevention of double taxation, concluded in 1899 between the Austro-Hungarian Empire and Prussia, largely followed the 1870 law. Following the success of the 1899 tax treaty, more tax treaties addressing double taxation were soon concluded between contiguous States. See e.g. Vogel 1986, 10; Jogarajan 2011, 690–692, 694–697 and 706. The first ancestor of the modern OECD MC, the League of Nations 1928 Model Convention, drew inspiration from the pre-World War I tax treaties. See League of Nations 1925, 12–15; League of Nations 1927, 8; League of Nations 1928, 6.

<sup>58</sup> Ruding Report 1992, 198; Shay, Fleming & Peroni 2002, 83; Helminen 2018b, ch. 3.

<sup>59</sup> Shay, Fleming & Peroni 2002, 83.

<sup>60</sup> Art. 3(3) TEU: "The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance."

<sup>61</sup> Art. 26(2) TFEU: "The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties."

<sup>62</sup> Urpilainen 2012, 51–52.

<sup>63</sup> C-67/08, *Block*, paras. 29–31; C-303/12, *Imfeld and Garcet*, para. 41; C-489/13, *Verest and Gerards*, para. 18.

<sup>64</sup> Cf. Terra & Wattel 2019, 47–48.

However, the ultimate objective of integration and coordination in the field of direct taxation is the creation of an area with no tax obstacles, including discrimination and disparities that discourage engaging in cross-border activities, and excessive compliance costs.<sup>65</sup> Unequal or discriminative taxation of cross-border activity is detrimental to a functional internal market, since differential tax treatment of resident and nonresident taxpayers as well as differential treatment of domestic and foreign investments or income may fragment the market along national borders of the Member States.<sup>66</sup>

The fundamental freedoms bring some degree of substance to the objective of establishing an internal market.<sup>67</sup> The EU tax law on direct taxation is largely built upon the interpretations of the Treaties and especially the fundamental freedoms. A few directives have also been introduced, addressing important, yet specific issues in the field of direct taxation.

## 2.3.2 Fundamental Freedoms

### 2.3.2.1 Introduction

The four fundamental freedoms<sup>68</sup> reflect the *principle of non-discrimination*<sup>69</sup> between domestic and cross-border situations enshrined in Art. 18 TFEU.<sup>70</sup> As special provisions, the fundamental freedoms are primary to the general non-discrimination provision of Art. 18 TFEU and, as the concept of discrimination in the fundamental freedoms is similar to that of Art. 18 TFEU, it leaves little room for standalone application of Art. 18 TFEU.<sup>71</sup> The fundamental freedoms are not tax provisions but rather embodiments of the general EU law principles.<sup>72</sup> Despite this, they have

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<sup>65</sup> Pistone & Szudoczky 2018, 39.

<sup>66</sup> Terra & Wattel 2019, 2.

<sup>67</sup> As Lazarov describes, “[t]he EU fundamental freedoms form the backbone of the internal market”. Lazarov 2018, 63.

<sup>68</sup> The free movement of goods (Arts. 28–37 TFEU), persons (Arts. 21, 45–48 and 49–55 TFEU), services (Arts. 56–62 TFEU) and capital (Arts. 63–66 and 75 TFEU). The free movement of persons actually encompasses three main categories, namely the right of residence (Art. 21 TFEU), the free movement of workers (Art. 45–48 TFEU) and the freedom of establishment (Arts. 49–55 TFEU). See e.g. Helminen 2018a, 73; Lazarov 2018, 65–67.

<sup>69</sup> In short, the principle of non-discrimination requires that comparable situations are not treated differently and different situations are not treated in a similar way. See e.g. C-513/04, *Kerckhaert and Morres*, para. 19. See also Wouters 1999, 98–106.

<sup>70</sup> Lazarov 2018, 63.

<sup>71</sup> Helminen 2018a, 74; Lazarov 2018, 69.

<sup>72</sup> Helminen 2018a, 32. There are no provisions concerning direct taxation in the Treaties. See *id.*

*direct effect* in direct tax cases, which has enabled them to become important provisions for direct taxation in the EU.<sup>73</sup>

### 2.3.2.2 Applying the Fundamental Freedoms

#### A Treaty Standing, Discrimination Approach and Restriction Approach

The fundamental freedoms only apply when there is a *Treaty standing*, which requires that there is a person with proper capacity and a cross-border element.<sup>74</sup> In other words, the fundamental freedoms are applicable only when, for example, a person resident in a Member State exercises the rights guaranteed in the fundamental freedoms directly or indirectly.<sup>75</sup> If there is Treaty standing, next, it must be evaluated whether the domestic legislation induces restriction to the fundamental freedoms. This evaluation may be based on *discrimination approach* or *restriction approach*. In the former approach, a national measure infringes the fundamental freedoms if it is directly or indirectly discriminative, i.e. it treats nonresidents worse than objectively *comparable* residents. In essence, the source State may not apply less beneficial tax treatment on nonresidents than on residents, if the nonresident and the resident taxpayer are in an objectively comparable situation with regard to the dividend distribution.<sup>76</sup> In the latter approach, the national measure does not have to be discriminative, but it may infringe the fundamental freedoms if it merely makes exercising of the rights guaranteed by the fundamental freedoms less appealing. In direct tax cases, the CJEU has traditionally based its judgements on the discrimination approach or on a mix of both approaches. The terminology the CJEU uses may be inconsistent at times. For example, the CJEU may state that a *restriction* may be permissible, if it relates to situations that are not objectively comparable.<sup>77</sup> However, many authors have actually suggested that even if the CJEU uses the language of ‘restrictions’, the approach is, nevertheless, the discrimination approach.<sup>78</sup>

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<sup>73</sup> Rosas & Armati 2012, 79; Helminen 2018a, 29; Lazarov 2018, 63.

<sup>74</sup> Terra & Wattel 2019, 49.

<sup>75</sup> Helminen 2018a, 74. The cross-border setting, i.e. exercising the rights guaranteed by the fundamental freedoms, may also be indirect. See e.g. C-403/03, *Schempp*, paras. 22–26, where the fact that Mr. Schempp’s former spouse had exercised her right to freedom of movement affected Mr. Schempp’s taxation and, therefore, granted him treaty access, even though he had not personally made use of the right to freedom of movement.

<sup>76</sup> See e.g. C-282/07, *Truck Center*, paras. 33 and 36–37.

<sup>77</sup> For more examples, see Opinion of AG Bobek in Case C-382/16, *Hornbach-Baumarkt*, paras. 40–42.

<sup>78</sup> See e.g. Terra & Wattel 2019, 86–94; Zalasinski 2017, 533–543; Lazarov 2018, 72–73. For case law, see e.g. C-319/02, *Manninen*, paras. 23–24; C-326/12, *Van Caster*, paras. 25–38; C-580/15, *Van der Weegen and Others*, paras. 29 and 33–35. See also Opinion of AG Bobek in Case C-382/16, *Hornbach-Baumarkt*, paras. 28–44. Indeed, *pure* restriction approach in direct taxation cases could lead to peculiar outcomes as AG Bobek points out in para. 38 of his opinion, since direct taxation essentially makes access to market always less appealing.

Terra & Wattel argue that in direct tax cases, the CJEU follows the discrimination-based approach and that in direct taxation, non-discriminatory restrictions, parallel exercise of taxing power and tax disparities are not in the scope of the fundamental freedoms.<sup>79</sup>

### *B Rule of Reason*

A discriminative national measure does not violate the fundamental freedoms if the measure is justified. The justification may be either explicit or unwritten. Firstly, the TFEU includes provisions that allow Member States to restrict the fundamental freedoms for certain reasons, such as public policy, security and health.<sup>80</sup> Since these provisions are a derogation from the fundamental freedoms, the CJEU applies them strictly.<sup>81</sup> The provisions containing the explicit justifications for restricting the fundamental freedoms are often limited by requiring that the prohibitions or restrictions may not constitute a means of arbitrary discrimination or a disguised restriction.<sup>82</sup>

Secondly, the CJEU may accept justifications under the *rule of reason* principle, even if they are not explicitly written in the TFEU. Under this principle, Member States may restrict the fundamental freedoms if the restriction can be justified by an overriding reason of public interest.<sup>83</sup> The explicit justifications and the rule of reason justifications partly overlap with respect to *indirect discrimination*, i.e. measures that are seemingly neutral but effectively lead to a discriminatory effect.<sup>84</sup> Indirectly discriminating provisions or *non-discriminatory restrictions* may be justified both under the express justifications provided in the TFEU and under the rule of reason principle.<sup>85</sup> *Direct discrimination*<sup>86</sup> that is based on nationality, i.e. treating similar situations differently or different situations similarly in a way that puts nonresidents in a worse position than residents, and *discriminatory restrictions* may only be justified under the explicit

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<sup>79</sup> Terra & Wattel 2019, 622 and 633.

<sup>80</sup> See e.g. Art. 36 TFEU on the free movement of goods.

<sup>81</sup> See e.g. C-322/11, *K*, para. 34; C-575/17, *Sofina*, para. 45.

<sup>82</sup> See e.g. Arts. 36 and 65 TFEU.

<sup>83</sup> Helminen 2018a, 132; Terra & Wattel 2019, 70.

<sup>84</sup> Indirect discrimination is also known as covert discrimination. For example, domestic tax legislation that seemingly does not distinguish between resident and nonresident taxpayers but would factually lead to more burdensome taxation of nonresidents, would be indirectly discriminative. See generally Wouters 1999, 103–104.

<sup>85</sup> Helminen 2018a, 132.

<sup>86</sup> Direct discrimination is also known as overt discrimination. See generally on the concept of discrimination e.g. Wouters 1999, 98–106; Helminen 2018a, 67–69.

justifications provided in the TFEU.<sup>87</sup> Even if a restriction is justified, it must still meet the requirements set forth by the *principle of proportionality*. In order for a restrictive measure to be proportionate, it must be suitable to achieving the justified objectives (*suitability test*) and it must restrict the fundamental freedoms as little as possible with still being suitable and effective enough (*necessity test*).<sup>88</sup>

### *C Subject-to-Tax Approach and Overall Approach*

The CJEU's approaches on limiting the fundamental freedoms and justifying the limitations may be elaborated a bit further. The CJEU has applied the *subject-to-tax approach* (*per country approach*) rather consistently in the more recent case law.<sup>89</sup> The starting point of the subject-to-tax approach is that resident and nonresident dividend recipients are not necessarily in an inherently comparable position, but they become comparable once the source State imposes tax liability to the resident and nonresident dividend recipients alike.<sup>90</sup> The source State may not subject nonresidents to less beneficial tax treatment than it subjects its residents to and thus, the taxation of residents sets practically the outer limits of the source State's right to tax nonresidents.<sup>91</sup> In essence, nonresidents cannot be taxed on income that is not included in the tax base of residents of the source State.<sup>92</sup>

Discriminatory source State taxation may be remedied in the State of residence, which makes the situation compatible with the EU law, if the remedy is based on a tax treaty.<sup>93</sup> This approach is called the *overall approach*, under which discriminatory taxation in the source State is allowed, if the nonresident taxpayer actually receives a corresponding tax credit in another State and this is agreed upon on a tax treaty. If the amount of tax due in the source State is more for the nonresident than for the resident taxpayer, the situation is still in line with the fundamental freedoms, if the nonresident taxpayer is credited in full in his State of residence. In such a situation, the overall

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<sup>87</sup> See e.g. C-311/97, *Royal Bank of Scotland*, para. 32; Joined Cases C-344/13 and C-367/13, *Blanco and Fabretti*, paras. 37–38; Helminen 2018a, 132.

<sup>88</sup> See e.g. Lazarov 2018, 97.

<sup>89</sup> Terra & Wattel 2019, 634.

<sup>90</sup> See e.g. C-170/05, *Denkavit*, paras. 34–35; C-575/17, *Sofina*, para. 47.

<sup>91</sup> Terra & Wattel 2019, 629. Reverse discrimination is not prohibited under the Treaties (yet it may induce illegal state aid). Therefore, a Member State may apply a more lenient tax treatment to nonresidents than to residents. See Helminen 2018a, 68.

<sup>92</sup> Terra & Wattel 2019, 629.

<sup>93</sup> See e.g. C-379/05, *Amurta*, para. 84. See also Terra & Wattel 2019, 644.

taxation of the nonresident taxpayer is not, in the end, less advantageous.<sup>94</sup> The source State cannot rely on unilateral measures adopted by the taxpayer's State of residence.<sup>95</sup> The overall approach seems to be an exception to the CJEU's practice of not approving counterbalancing incidental advantages provided for nonresidents as a justification for less advantageous treatment in some other issue.<sup>96</sup>

Besides the subject-to-tax approach and the overall approach, other approaches have also been applied, though mostly in older cases.<sup>97</sup> Firstly, under the *always-somewhere approach*, the CJEU argues that all charges and losses and the taxpayer's ability to pay must be taken into account somewhere in the internal market for tax purposes.<sup>98</sup> Secondly, the *mutual recognition approach* could be applicable in the procedural side of tax law, especially in the mutual recognition of documentary evidence.<sup>99</sup>

#### *D Summary*

To sum up, there are practically four steps in evaluating whether a domestic direct tax provision infringes the fundamental freedoms. Firstly, there must be a Treaty standing, thus excluding, for example, completely domestic settings from the scope of the fundamental freedoms. Secondly, the domestic measure must restrict one or more of the fundamental freedoms. In direct tax cases, this generally requires that the domestic measure discriminates nonresidents directly or indirectly, i.e. treats nonresidents less beneficially than objectively comparable residents. Thirdly, the restriction may be justified under explicit justifications provided in the TFEU or under the rule of reason principle. Fourthly, even if the object or purpose of the domestic measure is justified, the measure must be proportionate, i.e. suitable and necessary for achieving its justified object or purpose.

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<sup>94</sup> Cf. Simader 2013, 262.

<sup>95</sup> C-379/05, *Amurta*, para. 78. As stated in para. 77 of the *Amurta* judgement, the source State must *ensure* that "recipient companies established in another Member State are subject to the same treatment as recipient companies established in the [source State]". Unilateral measures are not in that sense ensured by the source State. See Simader 2013, 249–250.

<sup>96</sup> Terra & Wattel 2019, 644–647 and 692. See e.g. C-18/15, *Brisal*, para. 32; C-575/17, *Sofina*, para. 38.

<sup>97</sup> Terra & Wattel 2019, 634.

<sup>98</sup> *Id.*

<sup>99</sup> Terra & Wattel 2019, 642. Mutual recognition is not viable approach in direct tax matters, as it would require Member States to recognize each other's taxing rights and adjust their taxation accordingly, which would manifestly erode the tax sovereignty of Member States. See Terra & Wattel 2019, 641.



### 2.3.2.3 Which Fundamental Freedom Becomes Applicable?

Each fundamental freedom has an impact on direct taxation with the free movement of capital and the freedom of establishment bearing the most importance.<sup>100</sup> All of the fundamental freedoms have their own scope of application and there is often no difficulty in identifying the proper fundamental freedom for a given question.<sup>101</sup> However, it is not even necessary to analyse the delimitations of different fundamental freedoms in internal market situations, because similar analytical pattern is applied in all of the fundamental freedoms. In other words, there is a convergence between the fundamental freedoms, and it is not relevant, which fundamental freedom is eventually applied. In essence, all of the fundamental freedoms promote the fulfilment of the internal market as presented in Art. 26(2) TFEU.<sup>102</sup> A notable exception to the above is the free movement of capital, which is the only fundamental freedom that also applies with regard to non-EU States.<sup>103</sup> Obviously, this exception is not relevant in internal market situations, where no third countries are involved.

The CJEU looks at the *object and purpose* of the national legislation under scrutiny to determine, which fundamental freedom is applicable, with the principal purpose being decisive.<sup>104</sup> If the object and purpose of the national legislation are unclear, the CJEU looks at the facts of the case under evaluation in intra-EU situations.<sup>105</sup> Tax treatment of dividends may fall within the freedom of establishment (Art. 49 TFEU) and the free movement of capital (Art. 63 TFEU).<sup>106</sup> The freedom

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<sup>100</sup> Helminen 2018a, 79–126; Lazarov 2018, 63.

<sup>101</sup> Lazarov 2018, 69. The TFEU does not set any order of priority for the fundamental freedoms. See Dahlberg 2005, 287; Helminen 2018a, 126.

<sup>102</sup> See Urpilainen 2012, 67; Lazarov 2018, 69. Cf. also Dahlberg 2005, 84–85, arguing that there is a high degree of convergence but no complete convergence. However, Dahlberg states that “there is a strong resemblance between [the fundamental freedoms] in the way of identifying discrimination, non-discriminatory restrictions and acceptable grounds of justification, according to the rule-of-reason doctrine” and concludes that there is at least a large conformity in the interpretation and application of the fundamental freedoms.

<sup>103</sup> The purpose of the free movement of capital principle is not to unilaterally extend the applicability of the other fundamental freedoms to third State relations, which is why the distinction between the free movement of capital and the other freedoms (especially the freedom of establishment) is important in cases involving non-EU States. Generally, if the domestic legislation is aimed only at direct investments (or e.g. services), the free movement of capital is not applicable. On the other hand, if the scope of the domestic legislation is not restricted to relations of definite influence, the free movement of capital is applicable even if the case concerns holding of a substantive participation (direct investment) in situations involving non-EU States. See C-35/11, *Test Claimants in the FII Group Litigation*, paras. 96–104. See also Helminen 2018a, 128–129; Lazarov 2018, 69–70; Terra & Wattel 2019, 85 and 198–199.

<sup>104</sup> C-560/13, *Wagner-Raith*, para. 31; C-464/14, *SECIL*, para. 31; Helminen 2018a, 126–127; Lazarov 2018, 69–70.

<sup>105</sup> C-35/11, *Test Claimants in the FII Group Litigation*, paras. 93–94; C-168/11, *Beker*, paras. 27–28; C-375/12, *Bouanich*, para. 30.

<sup>106</sup> C-446/04, *Test Claimants in the FII Group Litigation*, para. 36; Joined Cases C-436/08 and C-437/08, *Haribo and Salinen*, para. 33; C-310/09, *Accor*, para. 30; C-35/11, *Test Claimants in the FII Group Litigation*, para. 89; C-168/11, *Beker*, para. 23; C-375/12, *Bouanich*, para. 26.

of establishment is applied, if the shareholder exerts definite influence over the company's decisions.<sup>107</sup> Therefore, the freedom of establishment is applied, if the national legislation concerns direct investments, that is, if the shareholder holds more than 10 per cent of the capital or votes in the company. However, it must always be considered whether the ownership creates a possibility to truly exert influence over the company's decisions. As the shareholder, by definition, does not exert definite influence in portfolio investments, only free movement of capital is applicable in cases concerning portfolio dividends.<sup>108</sup>

#### **2.3.2.4 Free Movement of Capital**

The legal basis for the free movement of capital is in Arts. 63–66 and 75 TFEU and the Capital Liberalization Directive.<sup>109</sup> Art. 63 TFEU prohibits Member States from maintaining legislation that restricts the movement of capital in or out of that Member State. The CJEU has interpreted this so that the rules, which discourage persons from making cross-border transactions, restrict the free movement of capital.<sup>110</sup> The term *movement of capital* is not defined in the TFEU, but it is apparent from the CJEU's case law that the definition is vast and includes, for example, cross-border investments in shares and real estates.<sup>111</sup>

Arts. 64–66 and 75 TFEU set limitations to the main principle of the free movement of capital laid down in Art. 63 TFEU.<sup>112</sup> Art. 65 TFEU explicitly allows Member States to treat domestic and

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<sup>107</sup> C-251/98, *Baars*, para. 22; C-470/04, *N*, para. 27–28; C-284/06, *Burda*, paras. 68–69; C-35/11, *Test Claimants in the FII Group Litigation*, para. 91; Joined Cases C-504/16 and C-613/16, *Deister Holding and Juhler Holding*, para. 78. See also Helminen 2018a, 127; Terra & Wattel 2019, 81–82. If the capital movement is merely an unavoidable side effect of exercising some other fundamental freedom guaranteed by the TFEU, the domestic legislation does not deserve an independent examination from the perspective of the free movement of capital. See C-284/06, *Burda*, para. 74.

<sup>108</sup> Joined Cases C-504/16 and C-613/16, *Deister Holding and Juhler Holding*, para. 78. See also Helminen 2018a, 127 and the cited case law.

<sup>109</sup> Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

<sup>110</sup> Cross-border transactions may be, for example, investments and loan contracts. See e.g. C-451/05, *ELISA*, para. 69; C-20/09, *Commission v Portugal*, para. 54.

<sup>111</sup> See e.g. Helminen 2018a, 115, and the cited case law. The CJEU has also considered that guidance to the definition of the term movement of capital may be sought from the nomenclature of capital movements set out in Annex I to the Capital Liberalization Directive. See e.g. C-513/03, *van Hilten*, para. 39; C-560/13, *Wagner-Raith*, para. 23.

<sup>112</sup> The standstill or 'grandfather' clause in Art. 64(1) TFEU allows Member States to keep applying 'old restrictions' as regards to direct investment and certain other categories of capital movements with respect to third countries. Such old restrictions must have existed on 31 December 1993 (or on a later date with few Member States) and must have been applied continuously since then. This limitation does not apply to e.g. portfolio dividends. Furthermore, Arts. 64(3) and 65(4) enable the Council to take or approve a 'step backwards' with respect to the liberalisation of capital movements to or from third countries. See Terra & Wattel 2019, 180.

Arts. 66 and 75 TFEU contain safeguarding provisions that allow the EU to react to threats without prejudice to Art. 63 TFEU. See further Helminen 2018a, 118–122.

cross-border settings differently for tax purposes.<sup>113</sup> The different treatment “shall not constitute means of arbitrary discrimination or a disguised restriction on the free movement of capital”.<sup>114</sup> Considering the CJEU’s praxis, the derogation from the principle of the free movement of capital must be interpreted strictly and, thus, there must be a proper justification for derogating from the principle in direct tax matters.<sup>115</sup> Therefore, the derogation based on Art. 65 TFEU is hardly different from the general rule of reason principle, which is applied with regard to the other fundamental freedoms. The CJEU may also apply the rule of reason principle in cases concerning the free movement of capital.<sup>116</sup>

### 2.3.3 Secondary Legislation

#### 2.3.3.1 Introduction

There is no secondary legislation directly addressing the taxation of portfolio dividends in the EU, thus leaving the tax treatment of portfolio dividends upon the domestic laws and tax treaties of Member States, international tax law, and the interpretations of the Treaties.<sup>117</sup> However, there are certain directives that are relevant to the taxation of portfolio dividends. The authorization for the Council of the European Union to issue directives on direct taxation is in Art. 115 TFEU.<sup>118</sup> Art. 115 TFEU requires unanimity, which has been notoriously difficult to achieve.<sup>119</sup> Thus, only four

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<sup>113</sup> Art. 65(1)(a) TFEU: without prejudice to Art. 63 TFEU, Member States may “apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested”. With respect to capital movements and payments between Member States, the domestic legislation providing for the different tax treatment must have existed already at the end of 1993. This limitation is based on Declaration on Article 73d of the Treaty Establishing the European Community, annexed to the Maastricht Treaty. See OJ 1992 C 191, 99. See also Helminen 2018a, 118. Art. 65(1)(b) concerns measures to prevent infringements of national law and regulations, measures laid down for informational purposes, and measures with *ordre public* justification.

<sup>114</sup> Art. 65(3) TFEU.

<sup>115</sup> See e.g. C-256/06, *Jäger*, paras. 40–43; C-43/07, *Arens-Sikken*, paras. 50–53; C-11/07, *Eckelkamp*, paras. 56–59.

<sup>116</sup> See Helminen 2018a, 118; Terra & Wattel 2019, 84–85. Terra & Wattel hypothesizes that (present) Art. 65(1) TFEU might have been included in the Maastricht Treaty in 1993 in order to protect national imputation systems that many Member States used to apply for alleviating economic double taxation of dividends. This hope was vain, as was apparent from the CJEU’s judgement e.g. in Case C-319/02, *Manninen*. Essentially, the provision proved to be mostly a codification of the CJEU’s rule of reason test. See Terra & Wattel 2019, 84–85. Other interpretations are also possible. Urpilainen points out that at the time of concluding the Maastricht Treaty, the CJEU’s case law was not as established as it is today and, thus, Member States may have been willing to safeguard their tax sovereignty from the possibly wide interpretations of the main rule in Art. 63 TFEU. See Urpilainen 2012, 190.

<sup>117</sup> The Parent-Subsidiary Directive eliminates withholding taxation of intercompany direct investment dividends, but portfolio dividends are not in the scope of the directive.

<sup>118</sup> Helminen 2018a, 37. The directives that are issued under the authorization of Art. 115 TFEU must directly affect the establishment or functioning of the internal market. This limitation sets borders to the degree of harmonisation in direct taxes that is achievable under the Treaties. See Art. 115 TFEU; Helminen 2018a, 37.

<sup>119</sup> Attempts to harmonise direct taxation in the EU through methods of positive harmonisation, such as directives, has faced significant challenges as positive harmonisation in the field of direct taxation generally requires unanimity

directives concerning direct taxation have been issued.<sup>120</sup> These directives are the Parent-Subsidiary Directive,<sup>121</sup> the Merger Directive,<sup>122</sup> the Interest and Royalties Directive,<sup>123</sup> and the Anti-Tax Avoidance Directive.<sup>124</sup> Especially the Parent-Subsidiary Directive is relevant for withholding taxation of dividends in the EU. Interest and Royalties Directive prohibits source State taxation of interest and royalty payments between associated companies<sup>125</sup> in the EU, and the Merger Directive concerns taxation in company reorganizations. The Anti-Tax Avoidance Directive (‘ATAD’) sets minimum standard to the anti-tax avoidance legislation of the Member States. The ATAD includes rules on interest limitation, exit tax, CFCs, hybrid mismatches and a general anti-avoidance rule.<sup>126</sup>

Recovery of tax claims from nonresidents generally requires international exchange of information and assistance from foreign authorities. Bi- and multilateral tax treaties may include provisions on the exchange of information and assistance in the collection of taxes, but the Member States have also concluded mutual treaties on administrative assistance and on information exchange.<sup>127</sup> Furthermore, the Convention on Mutual Administrative Assistance in Tax Matters<sup>128</sup> (‘MAATM Convention’) provides a possibility for the exchange of information and recovery of foreign tax

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among the Member States, who are mostly reluctant to give up their sovereignty in direct taxation. EU tax law on direct taxation has, therefore, mostly developed through negative integration, i.e. case-by-case judgements of the CJEU. See Terra & Wattel 2019, 45–47.

<sup>120</sup> Helminen 2018a, 40.

<sup>121</sup> Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 345, 29.12.2011, 8–16. Originally adopted in 1990, the directive was recast due to several amendments.

<sup>122</sup> Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States, OJ L 310, 25.11.2009, 34–46. Originally adopted in 1990, the directive was codified due to several amendments.

<sup>123</sup> Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26.6.2003, 49–54.

<sup>124</sup> Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, OJ L 193, 19.7.2016, 1–14 (‘ATAD I’) and Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries, OJ L 144, 7.6.2017, 1–11 (‘ATAD II’). The ATAD a part of the Anti-Tax Avoidance Package, which seeks to, *inter alia*, implement the OECD/G20 BEPS recommendations in the EU. See Commission 2016, 9.

<sup>125</sup> As defined in Art. 3(b) of the directive.

<sup>126</sup> See further e.g. Govind & Zolles 2018, 218–252; Helminen 2018a, 223–246. Not all of the rules are in force by the time of writing this.

<sup>127</sup> For example, Art. 26 of the OECD MC concerns exchange of information and Art. 27 concerns assistance in the collection of taxes. See also Helminen 2018a, 307.

<sup>128</sup> OECD & Council of Europe 2011.

claims.<sup>129</sup> However, for Member States, the Directive on Administrative Cooperation<sup>130</sup> and the Recovery Assistance Directive<sup>131</sup> are the most important sets of rules with respect to the administrative cooperation in dividend taxation in the internal market.<sup>132</sup> The Recovery Assistance Directive is especially interesting for providing means to safeguard the tax collection from taxpayers who are resident in other Member States, because traditionally, one of the main benefits of withholding taxes has been their effectiveness in ensuring taxation of nonresidents.<sup>133</sup>

### 2.3.3.2 Parent-Subsidiary Directive<sup>134</sup>

In principle, the Parent-Subsidiary Directive ('PSD') prohibits taxation of intercompany profit distributions, such as dividends, in direct investment situations within the EU. The PSD generally applies, if the parent company is resident in a Member State and the subsidiary is resident in another Member State and the parent company has a minimum holding of 10 per cent in the capital of the subsidiary either directly or through a permanent establishment.<sup>135</sup> Art. 5 PSD prohibits the State of residence of the subsidiary, i.e. the source State, from levying a withholding tax on the distributed profits. Therefore, as a main rule, source State dividend withholding taxation is prohibited in the EU in situations where the PSD applies. The PSD does not apply in portfolio dividends or in situations, where the dividend recipient is a natural person.<sup>136</sup>

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<sup>129</sup> Currently, 127 jurisdiction participate in the MAATM Convention. It was originally developed in 1988 by OECD and the Council of Europe and amended by Protocol in 2010. See <http://www.oecd.org/ctp/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm>.

<sup>130</sup> Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation and repealing Directive 77/799/EEC, OJ L 64, 11.3.2011, 1–12 ('DAC1'). The directive has already been amended several times: 'DAC2' (2014/107/EU), 'DAC3' (2015/2376/EU), 'DAC4' (2016/881/EU), 'DAC5' (2016/2258/EU) and 'DAC6' (2018/822/EU). Originally, the first directive concerning cooperation of Member States in tax matters was the Mutual Assistance Directive, which entered into force already in 1977 (Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, OJ L 336, 27.12.1977, 15–20). The Mutual Assistance Directive provided a framework for on-request information exchange and was later revised several times.

<sup>131</sup> Council Directive 2010/24/EU of 16 March 2010 concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures, OJ L 84, 31.3.2010, 1–12. The Directive has its roots in the late 70's in Directive 76/308/EEC, which concerned the recovery of e.g. agricultural subsidies and levies. It was first extended to cover VAT and excises in 1979 (Directive 79/1071/EEC) and, in 2001, to cover direct taxes (Directive 2001/44/EC). The old Recovery Assistance Directive was codified in 2008 (Directive 2008/55/EC) and finally repealed by the new Recovery Assistance Directive of 2010 ('RAD').

<sup>132</sup> Cf. Helminen 2018a, 307–308. The DAC and the RAD set the minimum level of administrative cooperation and therefore more extensive cooperation is possible e.g. under a tax treaty or the MAATM Convention. See e.g. Helminen 2018a, 308–309 and 340; Schilcher, Spies & Zirngast 2018, 293 and 303.

<sup>133</sup> See *infra* ch. 3.2.2.1.

<sup>134</sup> See generally e.g. Helminen 2018a, 151–171; Tenore 2018, 144–166.

<sup>135</sup> Arts. 1–3 PSD.

<sup>136</sup> In such cases, source State dividend withholding taxation may be prohibited under the fundamental freedoms.

### 2.3.3.3 Mutual Assistance in Direct Tax Matters

#### *A Directive on Administrative Cooperation*<sup>137</sup>

The Directive on Administrative Cooperation ('DAC') allows Member States to obtain information relevant for direct taxation from other Member States, when the information is foreseeably relevant to the administration and enforcement of the domestic laws of Member States.<sup>138</sup> The information may be relevant for correct tax assessment, but also for the recovery of the taxes covered.<sup>139</sup> The DAC provides rules for three types of exchange of information: exchange on request, mandatory automatic exchange and spontaneous exchange.

Exchange on request allows a Member State to request any information that is foreseeably relevant to the administration and enforcement of its tax laws from another Member State. The request has to relate to a specific case, which precludes mass enquiries or 'fishing expeditions' under the directive.<sup>140</sup> The requesting Member State should also provide the identity of the person under examination or investigation and the tax purpose for which the information is needed.<sup>141</sup> Given that the information request meets the conditions set in the directive, the requested Member State is obliged to provide the requested information within the time limits set in Art. 7 DAC, unless it can rely on the grounds of refusal provided for in Art. 17 DAC.<sup>142</sup> The requested Member State is not required to comply with the request, if the information request is manifestly devoid of any foreseeable relevance.<sup>143</sup> Member States may apply the exchange on request to verify the correctness of information reported by a nonresident taxpayer. Member States are, nevertheless, not obliged to make use of the directive on their own initiative to retrieve information.<sup>144</sup> However, if a nonresident taxpayer applies for a tax benefit and provides information in support of the

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<sup>137</sup> See generally e.g. Helminen 2018a, 307–340; Schilcher, Spies & Zirngast 2018, 257–295.

<sup>138</sup> Arts. 1(1) and 2 DAC. See also Helminen 2018a, 310–311.

<sup>139</sup> Schilcher, Spies & Zirngast 2018, 261.

<sup>140</sup> Arts. 3(8) and 5 DAC; Schilcher, Spies & Zirngast 2018, 265.

<sup>141</sup> Art. 20(2) DAC. See also Schilcher, Spies & Zirngast 2018, 265.

<sup>142</sup> Under Art. 6 DAC, the requested Member State must apply the same procedures as it would when acting on its own initiative. Obviously, it is possible that the requested Member State cannot produce the requested information. In such a situation, it must inform the requesting authority immediately and within one month at the latest. See Art. 7(6) DAC.

<sup>143</sup> C-682/15, *Berlioz*, paras. 71–72 and 78–82.

<sup>144</sup> See e.g. C-276/12, *Sabou*, para. 33. See also Nijkeuter 2011, 233–234; Helminen 2018a, 310; Schilcher, Spies & Zirngast 2018, 266.

application, the benefit cannot be denied on the grounds that the information cannot be verified, if the needed information could be verified with measures provided for in the DAC.<sup>145</sup>

The rules on mandatory automatic exchange of information require Member States to exchange certain information on predetermined intervals on a standard computerized format. Especially the adoption of DAC2<sup>146</sup> induced a change in cross-border information flow of dividend distributions, when automatic financial account information reporting was made mandatory between Member States.<sup>147</sup> DAC2 effectively implemented the OECD Common Reporting Standard (‘CRS’) within the EU.<sup>148</sup> Since all Member States have also implemented the OECD CRS,<sup>149</sup> DAC2 hardly makes a difference with regard to the information that Member States exchange between each other. According to the preamble to DAC2, Member States should refer to the OECD Commentaries on the Model Competent Authority Agreement and the Common Reporting Standard<sup>150</sup> (‘CRS Commentary’) for interpretative guidelines.<sup>151</sup> Therefore, in the following, references are also made to the CRS Commentary. Broadly, DAC2 obliges *Reporting Financial Institutions*,<sup>152</sup> such as custodial institutions resident in a Member State, to report extensive identification information<sup>153</sup> on persons holding *Reportable Accounts*<sup>154</sup> in that financial institution. The financial institution must also report the balance or value of the reportable account at the end of the reporting period (usually at the end of the year) and the gross amount of payments, such as dividends, to the account or with respect to it.<sup>155</sup> The Reporting Financial Institution reports the

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<sup>145</sup> Cf. Nijkeuter 2011, 233.

<sup>146</sup> Council Directive 2014/107/EU of 9 December 2014 amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation, OJ L 359, 16.12.2014, 1–29.

<sup>147</sup> Member States are also obliged to automatically exchange information on certain specific categories of income and capital (DAC1), advance cross-border tax rulings and advance pricing arrangements (DAC3), country-by-country reports (DAC4), and potentially aggressive tax planning arrangements (DAC6, the deadline for implementation is 31 December 2019). By DAC5, tax authorities gained access to the beneficial ownership information collected under the anti-money laundering legislation, which is relevant for the financial account information reporting under DAC2. See generally Helminen 2018a, 312–327; Schilcher, Spies & Zirmgast 2018, 266–279. With respect to an overview and assessment of automatic exchange of information under DAC1, DAC2 and DAC3, see Commission 2018.

<sup>148</sup> See Recital 9 of the preamble to the amending Directive 2014/107/EU.

<sup>149</sup> See <http://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/crs-by-jurisdiction/>.

<sup>150</sup> OECD 2017.

<sup>151</sup> Recital 13 of the preamble to the amending Directive 2014/107/EU.

<sup>152</sup> For detailed definition, see OECD 2017, 158–174.

<sup>153</sup> See further OECD 2017, 94–97 and 102–105.

<sup>154</sup> For detailed definition, see OECD 2017, 175–199.

<sup>155</sup> See further OECD 2017, 94–96, 98–102 and 105.

information to the competent authority of its State of residence and the competent authorities automatically exchange this information on an annual basis.<sup>156</sup>

Lastly, the DAC requires Member States to exchange information spontaneously without prior request in some cases.<sup>157</sup> For example, information exchange is required when the competent authority of a Member State becomes aware of a possibility that a taxpayer may get an unjustified saving of tax in another Member State or when a taxpayer obtains a tax reduction or exemption that would give rise to a corresponding tax liability in another Member State.<sup>158</sup> Member States may also forward spontaneously any information they are aware of, which they deem potentially useful to the other Member State.<sup>159</sup>

### *B Recovery Assistance Directive<sup>160</sup>*

The Recovery Assistance Directive ('RAD') enables Member States to recover their tax claims and to carry out precautionary measures to ensure the recovery of tax claims on the territory of another Member State.<sup>161</sup> The RAD also includes provisions on spontaneous and on-request exchange of information.<sup>162</sup> The spontaneous exchange of information concerns refunds of tax other than value-added tax and the on-request exchange of information concerns any information, which is foreseeably relevant for the requesting Member State to the recovery of its tax claims.<sup>163</sup>

Under the Recovery Assistance Directive, Member States must assist each other in recovering enforceable tax claims upon request after the requesting Member State has exhausted its domestic remedies.<sup>164</sup> A Member State must also take precautionary measures upon request of another

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<sup>156</sup> Arts. 8(3a) and 8(6)(b) DAC.

<sup>157</sup> Arts. 9(1) and 10 DAC. According to Art. 9(1) DAC, the five cases are: (a) suspicion of loss of tax (unjustified saving of tax) in another Member State, (b) tax reduction or exemption that would incur a corresponding tax liability in another Member State, (c) cross-border business dealings conducted through one or more countries that may result in saving in tax, (d) suspicion of tax savings resulting from artificial transfers of profits within group of enterprises, and (e) information forwarded to a Member State has enabled information to be obtained that may be relevant in assessing tax liability in the forwarding Member State.

<sup>158</sup> Arts. 9(1)(a)–(b) DAC. See also C-420/98, *W.N.*, paras. 22–24; Schilcher, Spies & Zirngast 2018, 279.

<sup>159</sup> Art. 9(2) DAC.

<sup>160</sup> See generally e.g. Helminen 2018a, 340–351; Schilcher, Spies & Zirngast 2018, 296–304.

<sup>161</sup> Arts. 10–15 and 16–17 RAD, respectively.

<sup>162</sup> Arts. 5–6 RAD. Furthermore, the RAD includes provisions on collaboration by officials of Member States (Art. 7) and assistance for the notification of documents (Arts. 8–9).

<sup>163</sup> Schilcher, Spies & Zirngast 2018, 298.

<sup>164</sup> Arts. 10 and 11(2) RAD. There are two exceptions provided in Art. 11(2) of the Directive to the requirement that the requesting Member State must first exhaust its domestic remedies. If it is obvious that there are no recoverable assets in the requesting Member State and the requesting authority has specific information that there are such assets



Member State to ensure the recovery where the claim is contested, or even before the instrument permitting the enforcement is issued, if the laws of both Member States allow for such measures.<sup>165</sup> In principle, providing mutual assistance stipulated in the RAD is obligatory to the requested Member State if the prerequisites for assistance are fulfilled. However, the RAD includes three explicit grounds for refusal of assistance.<sup>166</sup> Most notably, the requested Member State may refuse from granting assistance if the total amount of the claims is less than EUR 1,500.<sup>167</sup> This *de minimis* threshold seems to allow for refusal of assistance in cases where the administrative burden is clearly disproportionate to the benefits to be derived.<sup>168</sup>

### *C Effectiveness of Recovery Assistance in Practice*

According to a Commission follow-up report on the RAD,<sup>169</sup> published in late 2017, and the accompanying Staff Working Document,<sup>170</sup> Member States have perceived that the RAD has primarily had a positive effect on the collection and recovery of tax related claims.<sup>171</sup> However, the results are quite poor in cases that would be complex also domestically, such as non-collection due to fraudulent behaviour of the taxpayer.<sup>172</sup> The success of Member States to recover taxes on behalf of Member States varies significantly, but is not flattering even at its best. Only four Member States succeeded to recover on average over 10 per cent of the amounts for which recovery assistance was requested in 2013–2016, whereas 13 out of 28 Member States succeeded to recover on average less than 2 per cent of the amounts.<sup>173</sup>

However, as stated by France, in terms of number of requests, the success rate is much higher.<sup>174</sup> The poor results may be partially due to a small number of high value cases that may include heavy

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in the requested Member State, the requesting Member State may resort directly to the requested Member State. Similarly, exhausting domestic remedies is not required if it were disproportionately difficult.

<sup>165</sup> Art. 16(1) RAD.

<sup>166</sup> Art. 18 RAD.

<sup>167</sup> Art. 18(3) RAD. Furthermore, Art. 18 RAD allows the requested Member State not to provide recovery assistance, if the recovery of the claim would incur serious economic or social difficulties to the taxpayer, or if the initial request concerns claims which are more than five years old (with some exceptions). See Helminen 2018a, 347–348.

<sup>168</sup> Schilcher, Spies & Zirngast 2018, 303.

<sup>169</sup> COM(2017) 778 final, hereinafter ‘Commission 2017b’.

<sup>170</sup> SWD(2017) 461 final, hereinafter ‘Commission 2017c’.

<sup>171</sup> Commission 2017b, 3 and 5.

<sup>172</sup> Commission 2017b, 4.

<sup>173</sup> Finland had the highest success rate, 26.52 per cent, with the Netherlands following as second at 16.60 per cent. See Commission 2017c, 18–19.

<sup>174</sup> As France puts it explaining its recovery results: “If we consider the **number of requests**: about 40 % of them have been followed 2 years later by payments of the debt (complete or partial payment), thanks to the assistance provided by the requested Member State.” Commission 2017c, 16.

penalties on top of the original tax claim and also fraudulent behaviour by the taxpayer or, for example, insolvency.<sup>175</sup> Another concern is that Member States may lack the resources needed for effective recovery assistance.<sup>176</sup> The number of recovery assistance requests is trending upwards, yet it is quite modest, topping to *circa* 16,000 in 2016.<sup>177</sup> Still, 18 Member States consider that the number of incoming recovery requests is burdensome or somewhat burdensome.<sup>178</sup> This reinforces the impression that ‘difficult cases’ may be overrepresented in the recovery assistance requests. On the other hand, the perception of some Member States that not all Member States do necessarily prioritize recovery assistance and assign proper resources to it is also reinforced.<sup>179</sup> Lastly, the availability of mutual assistance procedures, not only the recovery collection assistance but also the exchange of information, is likely to have a deterrent effect towards non-compliance, thus increasing voluntary compliance, yet determining the ‘value’ of the deterrent effect is difficult.<sup>180</sup> Overall, the RAD seems to provide an effective mechanism for recovery assistance when compared to other agreements.<sup>181</sup> Then again, the efficiency of tax collection from abroad appears to be manifestly ineffective even under the RAD to be applied in a mundane basis, which is also reflected in the directive itself in the *de minimis* threshold of EUR 1,500.

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<sup>175</sup> Cf. Commission 2017c, 16–17. According to a Belgian study, the mutual recovery assistance generally produces either the complete claim or nothing at all. See Commission 2017c, 17, referring to a Belgian Court of Audit study from 2014.

<sup>176</sup> Commission 2017b, 6.

<sup>177</sup> Commission 2017c, 13.

<sup>178</sup> Commission 2017c, 31. There is a broad variance in the number of incoming requests for recovery assistance between the Member States. See *id.*

<sup>179</sup> See Commission 2017b, 6.

<sup>180</sup> Commission 2017c, 21–22; Commission 2018, 13–14.

<sup>181</sup> Commission 2017c, 40.

## 3 Withholding Tax

### 3.1 What Is Tax Withholding?

#### 3.1.1 Source State Tax Withholding

The prevalent method for the source State to collect taxes on income paid to nonresidents is through *withholding taxes*, where the tax is collected through tax withholding. Income tax withholding has been in the toolbox of revenue authorities at least since the early 19<sup>th</sup> century as tax authorities and policymakers discovered that harnessing the power and knowledge of third parties greatly enhances tax compliance.<sup>182</sup> *Tax withholding* refers to a procedure for charging taxes, where the payer of the income (*withholding agent*) charges the tax from the income payable to the income recipient and transfers the charged amount to the tax authorities on behalf of the income recipient.<sup>183</sup> The underpinning idea of tax withholding is that it is effective to collect income taxes at the source of the income, that is, by deducting the tax from the amount payable before paying the income. Withholding is widely applied for tax collection both in domestic and cross-border settings.<sup>184</sup>

The tax assessment procedure involving withholding may vary depending on the source of the income<sup>185</sup> and the recipient of the income. Tax assessment procedures involving tax withholding may be classified in two categories from the taxpayer's point of view. States apply *provisional withholding* especially in domestic settings. Provisional withholding is generally the first step of the tax assessment procedure, serving as an advance payment of taxes.<sup>186</sup> It is followed by final tax assessment, where the taxpayer's annual tax liability is compared to the aggregate amount of taxes withheld from that taxpayer during the given year. The comparison may be done in an annual tax return. The possible difference of the annual tax liability and the aggregate amount of taxes

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<sup>182</sup> Mehrotra 2016, 146. A crude form of income withholding was introduced in Great Britain in 1803, where the tax was 'stopped at the source', that is, the payer of the income deducted the amount of tax from the income payable to the income recipient and paid the taxes on the income recipient's behalf. The effectiveness of the 'stoppage-at-source', as withholding was called, was among the reasons why it was adopted. See e.g. Seligman 1911, 90–91, citing a document explaining the reasons behind the alteration of the method of assessment; Twight 1995, 385–386; Desai 2014, 869; Mehrotra 2016, 146.

<sup>183</sup> Lee & Yoon 2018, 11.

<sup>184</sup> See *infra* text accompanying note 191 and ch. 4.1.

<sup>185</sup> Meaning both territorial source and income type (e.g. dividend, interest, salary).

<sup>186</sup> Provisional withholding taxes may also be adjusted before withholding in order to match the amount of the withheld taxes more accurately with the final tax burden.

withheld is settled through tax refund or back taxes.<sup>187</sup> In cross-border settings, States prevalently apply a cruder tax assessment procedure of *final withholding*, where the withheld tax is the taxpayer's final tax burden in the source State.<sup>188</sup> The personal circumstances of the income recipient are not considered, and the taxable amount is generally calculated as a percentage of the gross income.<sup>189</sup> Final withholding does not involve any significant subsequent steps; for example, there is no need for subsequent comparison of annual tax liability and aggregate amount of taxes withheld in an annual tax return with respect to the income item that has been taxed in the final withholding procedure. Therefore, a nonresident taxpayer is not usually required to file an income tax return in the source State.<sup>190</sup>

States usually levy final withholding tax on dividends paid to nonresidents.<sup>191</sup> For example, Finland levies, in principle, a source tax of 20 per cent on the gross amount of dividends paid to a foreign company and a source tax of 30 per cent of the gross amount, if the dividend recipient is a foreign natural person.<sup>192</sup> Tax treaties usually limit the source State's taxing right to 15 per cent of the gross amount of portfolio dividends or to 5 per cent of the gross amount of dividends, when the dividend recipient is a company holding a sufficient amount of the capital (e.g. 25 per cent) of the dividend distributing company, yet the exact figures may be different in the actual tax treaties.<sup>193</sup> Further restrictions on the Member States' right to levy source tax on dividends may be imposed in secondary legislation or derive from the fundamental freedoms.<sup>194</sup>

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<sup>187</sup> Lee & Yoon 2018, 12, 15, 17 and 20–21.

<sup>188</sup> Lee & Yoon 2018, 26.

<sup>189</sup> Lee & Yoon 2018, 22.

<sup>190</sup> Lee & Yoon 2018, 20 and 26.

<sup>191</sup> Lee & Yoon 2018, 22–23. For example, a vast majority of EU Member States levy withholding tax on dividends paid to nonresidents. Few exceptions are e.g. Cyprus and the United Kingdom. See generally the respective chapters in PwC 2018.

<sup>192</sup> According to Sec. 9(1)(2) of the Finnish Income Tax Act (Tuloverolaki, TVL, 1535/1992), nonresident legal and natural persons (i.e. persons with limited tax liability) are liable to pay tax on Finnish-source income. Under Sec. 10(1)(6) TVL, Finnish-source income includes, *inter alia*, dividends distributed by a Finnish company. The taxation of nonresidents is generally stipulated in the Finnish Act on the Taxation of Income of a Person Subject to Limited Tax Liability (Laki rajoitetusti verovelvollisen tulon verottamisesta, LähdeVL, 627/1978). On taxation of nonresidents in Finland generally, see Nykänen 2015.

<sup>193</sup> The OECD MC has capped the source tax rate to 5 per cent on gross amount of the dividends, when the dividend recipient is a company owning at least 25 per cent of the capital of the dividend distributing company and to 15 per cent of the gross amount of the dividends in all other cases. The OECD Model Conventions have contained the same figures since 1963. See Art. 10 OECD MC 2017 and OECD 2015, M-28. In actual tax treaties, the maximum tax rates allowed for the source State may differ from the rates adopted in the OECD MC. Similarly, the holding requirement for direct investment may be other than the 25 per cent referred to in the OECD MC. See e.g. Helminen 2010a, 25.

<sup>194</sup> Helminen 2018a, 29–30. In Finland, such restrictions are, for example, the exception based on the Parent-Subsidiary Directive in Sec. 3(6) LähdeVL and the exception in Sec. 3(5) LähdeVL, according to which dividends

Traditionally, the use of withholding taxes in cross-border settings has been especially with the difficulties States may face when taxing nonresidents. In principle, States do not allow enforcement of foreign tax claims on their territory unless such is reciprocally agreed between the States.<sup>195</sup> Therefore, it is practical for the source State to impose taxes on the objects that are available within its jurisdiction (for example, income before it has been paid to a nonresident), as the tax subject (the nonresident taxpayer) is not available. Furthermore, the source State cannot efficiently gather information on the nonresident taxpayer's worldwide income and expenses as well as other personal circumstances that affect the taxpayer's ability to pay taxes.<sup>196</sup> The mutual assistance procedures have significantly eroded the relevance of these reasons, because Member States may rely, for example, on the DAC and the RAD for information exchange and assistance in tax collection.<sup>197</sup>

A conceptually important point is to differentiate tax withholding from current tax payment and information reporting. *Current tax payment* refers to a system where the taxes become payable at the time the taxable transaction occurs.<sup>198</sup> For example, taxation of cross-border dividends is typically current taxation, as the dividend tax becomes payable upon the dividend distribution. In the context of withholding taxes, *information reporting* means generally that the payer of the income reports certain information on the taxpayer and the income to tax authorities, such as identifying information and the amount of income paid. In theory, tax withholding does not necessitate current tax payment and information reporting.<sup>199</sup> In practice, however, modern tax

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received by entities resident in an EU or EEA Member State may be exempt from the source tax if dividends received by a corresponding domestic entity would be tax exempt. See further Nykänen 2015, 220–224.

<sup>195</sup> Terra & Wattel 2019, 612–613. This is also known as the *revenue rule*. See Shay, Fleming & Peroni 2002, 119–120; Rohatgi 2007, 21; Terra & Wattel 2019, 595. See also Dutta 2006, 697–724.

<sup>196</sup> Terra & Wattel 2019, 613.

<sup>197</sup> *Id.* Internationally available instruments include e.g. the information exchange and recovery assistance agreements in Arts. 26–27 of the OECD MC and the MAATM Convention.

<sup>198</sup> See e.g. Desai 2014, 869.

<sup>199</sup> In the early 1940s, England and Australia applied tax withholding ‘non-currently’ to collect taxes arising from the previous assessment period. See Lent 1942, 720–721. Theoretically, final withholding system could also work without obligating the withholding agent to report any information on the taxpayer to the tax authorities. Such a system would require a flat rate final withholding tax be levied at the same rate with no regard to the person, residence or personal situation of the taxpayer. For example, a dividend distributing company could be required to charge a 15 per cent final withholding tax on the gross amount of the distributed dividends regardless of any qualities of the dividend recipients. This would obviously violate the Parent-Subsidiary Directive and at least most of the tax treaties, too, as the tax would not differentiate between direct investment and portfolio investment relationships. Alternatively, the dividend distributor could be obligated to apply different rates for different dividend recipients in order to meet the requirements of the Parent-Subsidiary Directive and the tax treaties, but tax authorities would not supervise this at all. Neither of the alternatives seem feasible, which is why information reporting of at least some degree could be regarded as necessary for a workable withholding tax system.

withholding regimes rarely, if ever, exist without information reporting and current tax payment. On the contrary, current tax payment and information reporting do not necessitate tax withholding. The taxpayer may be required to pay tax ‘currently’ in self-assessment procedure where there is no withholding agent involved. For example, advance payment or preassessment of taxes may be regarded as an approximation of current tax payment, where the taxpayer personally sees to the payment of the tax.<sup>200</sup> As observed above, information reporting obviously exists also independently.<sup>201</sup> However, due to the intertwinement of tax withholding with current tax payment and information reporting, for the purposes of this study, it is practical to suppose that the withholding agent is required to report information to tax authorities and that the tax is withheld ‘currently’. Furthermore, final tax is by definition such that does not involve any regular steps subsequent to the payment of the tax.<sup>202</sup> This includes the tax collection, and therefore all tax collection systems, where the final tax is assessed and collected at the time of the taxable transaction necessitate current tax payment. Therefore, final withholding tax is always paid currently. Still, it is important to note that tax withholding, current tax payment and information reporting each add different benefits and disadvantages to the tax system.

### 3.1.2 Different Viewpoints to Tax Withholding

Tax withholding may be evaluated from the point of view of the taxpayer, the State, and the withholding agent. The evaluation may be done with respect to tax withholding as a method *per se* or with respect to the whole tax assessment procedure involving tax withholding. For the withholding agent, the withholding obligation incurs compliance costs and risk of penalties. The withholding agent usually has to collect relevant facts regarding the income recipient and withhold a correct amount of tax at risk of penalties for no compensation at all or only a minimal compensation.<sup>203</sup> Practicality sets many limits to what can be required of the withholding agent, who is typically a private (legal) person with limited authority and resources.<sup>204</sup> In essence, the withholding agent cannot compel the taxpayer to produce information that is relevant for correct withholding, but merely incentivize the taxpayer within the boundaries set in the domestic

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<sup>200</sup> See e.g. Sec. 23 of the Finnish Act on Prepayment of Tax (Ennakkoperintälaki, EPL 1118/1996).

<sup>201</sup> For example, under the CRS, Financial Institutions are required to report certain information to tax authorities. See *supra* ch. 2.3.3.3.

<sup>202</sup> The possibility to appeal against the tax assessment decision or the taxpayer’s possibility to claim for refund does not count as a ‘regular step’.

<sup>203</sup> See e.g. Soos 1990, 186–187; Lee & Yoon 2018, 42 and 44.

<sup>204</sup> Lee & Yoon 2018, 11.

legislation of the withholding agent's State of residence. Such 'incentives' could be, for example, the threat of applying a higher withholding tax rate in case of non-cooperation.<sup>205</sup> The challenges of the withholding agent are admittedly real.<sup>206</sup> From the EU law perspective, the withholding obligation may – and, actually, does – constitute a restriction to the fundamental freedoms, for example, by rendering acquiring foreign financing less attractive than domestic financing. A company with nonresident shareholders or a debtor with nonresident creditors may be obliged to withhold source tax on dividend distributions or interest payments to nonresidents, which it might not be obliged to do, if it had only resident shareholders or debtors. This incurs additional administrative burden and risks of liability to the company.<sup>207</sup> Such restriction is, however, justified under the need to ensure the effective collection of tax and, according to the CJEU, tax withholding combined with liability rules that encourage the withholding agent to comply with the obligation diligently are an appropriate and proportionate means of ensuring the effective collection of taxes from nonresident taxpayers.<sup>208</sup>

When evaluating tax withholding from the perspective of the taxpayer and the State, the struggles of the withholding agent boil down to being a necessary element enabling tax withholding, but nothing more. From this isolated perspective, the efforts, challenges or costs that the withholding agent encounters have no value in itself. Therefore, for the purposes of this study, the challenges are not evaluated separately but from within the taxpayer's and the State's point of view as setting the practical limits of what can and what cannot be achieved with tax withholding, i.e. what the withholding agent can practically do and what it cannot do.

The viewpoint of the taxpayer and the State are of importance. In broad terms, the simplicity, effectiveness and enforceability of tax withholding benefits directly the State, but the taxpayer also

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<sup>205</sup> See e.g. Lee & Yoon 2018, 20 and 27.

<sup>206</sup> See e.g. Lee & Yoon 2018, 11, 19–20, 27 and 32.

<sup>207</sup> See the recent Grand Chamber judgement of 26 February 2019 in Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg 1 and Others v Skatteministeriet*, para. 159. The cases concerned taxation of cross-border interests, but with regard to the withholding agent, there is no difference in principle whether the tax to be withheld is based on interest payments or dividend distributions. Unfortunately, the CJEU did not comment on the compatibility of withholding obligation with the fundamental freedoms in another judgement given on the same day and concerning the same group of companies, namely Joined Cases C-116/16 and C-117/16, *Skatteministeriet v T Danmark and Y Denmark Aps*. These cases concerned taxation of cross-border dividends. The CJEU passed the questions concerning the compatibility of withholding obligation with the fundamental freedoms by stating that the fundamental freedoms cannot be relied on for fraudulent or abusive purposes (paras. 122–123 of the judgement).

<sup>208</sup> Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg 1 and Others v Skatteministeriet*, para. 160.

benefits from a simple tax system that facilitates compliance, which both provisional and especially final withholding essentially are. The trade-off of simplicity is the lack of sensitivity. This may cause direct disadvantages to the taxpayer, for example, in the form of inability to deduct expenses, but it may be disadvantageous to the State as well, because the State may, for example, be ‘required’ to apply lower tax rates to compensate for levying tax on gross income.<sup>209</sup> The benefits and disadvantages of tax withholding are also somewhat dependent on the entire tax assessment procedure and the part that tax withholding plays in it. Essentially, some flaws of tax withholding may be ‘made up’ in later stages of the tax assessment procedure, thus making it less simple but more sensitive to the personal situation of the taxpayer. However, some benefits and disadvantages are inherent to tax withholding. These benefits are such that could be difficult to achieve by using different tax collection methods and they are common to provisional and final withholding.<sup>210</sup> Further benefits and disadvantages depend on the tax system. In provisional withholding, the steps preceding and subsequent to the tax withholding may mitigate the initial shortcomings of tax withholding, essentially the lack of sensitivity. As a trade-off, these steps usually increase the complexity of the tax assessment procedure and, in cross-border settings, may incur enforceability problems. In final withholding, the tax assessment procedure pretty much begins and ends at the withholding. As a ‘benefit’, this removes the problems related to the provisional withholding, but as a ‘disadvantage’, forgoes the advantages.

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<sup>209</sup> Levying tax on gross income is less sensitive to the taxpayer’s ability to pay and thus it can either result in ‘undertaxation’ when compared to the ability to pay and a ‘preferred total tax burden’, or vice versa, in overtaxation. For example, activities with high net profit margin may actually benefit from gross taxation if it is subject to a relatively low tax rate (e.g. 15 per cent) as compared to net taxation with a relatively high tax rate (e.g. 30 per cent). Low net margin activities, on the other hand, may turn unprofitable due to gross taxation. See van der Jagt 2012, 153, for an illustrating example. Although the example concerns taxation of interest, the figures could as well concern dividends. See also opinion of AG Kokott in case C-105/08, *Commission v Portugal*, paras. 36–37.

<sup>210</sup> It is also important to bear in mind that tax withholding spread in widespread use in time, when data processing was immensely more difficult. It is easy to imagine that modern data processing and communication technologies could enable different solutions for building a well-functioning tax system. Tax systems are, however, slow to change, which makes it rather safe to say that tax withholding – that the payer of the income charges the tax amount and transfers it to the tax authorities – is still going to stick around for a long time to come. Cf. Lee & Yoon 2018, 10.



## 3.2 Benefits and Disadvantages of Final Withholding Taxes in Cross-Border Settings

### 3.2.1 Framework for Analysis

A tax collection system is not inherently ‘good’ or ‘bad’ – it simply contributes to the objectives set to a tax system well or poorly. Therefore, it is essential to set up a framework against which the benefits and disadvantages of tax withholding are evaluated. Such framework may be found from the desirable qualities of an income tax system.<sup>211</sup> The first differentiation to be made is between the *objectives* of a tax system and the *means* to attain those objectives. In the broadest sense, the objective of a tax system may be, for example, fulfilling the State’s fiscal needs with reasonable administrative costs, levying taxes from taxpayers according to their taxpaying capacity, steering citizens to behave in some way that is considered suitable by the State’s policymakers, and so on. A quote from the final report of the Mirrlees Review, *Tax By Design*, illustrates well relevant aspects of designing a good tax system in the 21<sup>st</sup> century: “The challenge in this review has been to design a tax system that can raise the revenue that government needs to achieve its spending and distributional ambitions whilst minimizing economic and administrative inefficiency, keeping the system as simple and transparent as possible, and avoiding arbitrary tax differentiation across people and forms of economic activity.”<sup>212</sup> The means, by contrast, are the way to the objectives. In dividend taxation, the means is essentially the process applied for assessing and collecting taxes.

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<sup>211</sup> Arguably, different points are emphasised in the design of international tax system than in the design of a domestic tax system. For example, equity between States (*inter-nation equity*) is hardly the primary consideration in States’ domestic tax systems. See Brooks 2008, 1–2. From the taxpayer’s perspective, however, the obligation to pay taxes results in a similar outcome (reduction of the after-tax income) regardless of whether the State imposing the taxpaying obligation is the taxpayer’s State of residence or some other State. Therefore, it is reasonable to expect that the traditional virtues of a ‘good tax system’ (efficiency, equity, simplicity and administrability) are desirable also in international context, let alone in the internal market.

The general discussion of ‘what is a good tax system like’ would require noting many aspects that are also of political nature. For example, the total fiscal need, manifest in the broadness of tax base and tax rates, is essentially a political question relating to the functions of a State. A steering effect may also be pursued (e.g. environmental taxes, sin taxes) or, alternatively, a neutral tax system may be the goal. The objective of a tax system may be that it is steering on some issues and neutral on others, depending on the political preferences. For example, States may aim for steering effect in taxation of goods that are harmful for the environment or health and neutrality in taxation of cross-border trade. See generally on the qualities of a good tax system e.g. Sneed 1965, 567–613; Shome 1995, 3–19; Zee 1995a, 25–29; Zee 1995b, 30–34; Juusela 1998, 48–84 Mirrlees et al. 2011; Myrsky 2013, 131–144.

<sup>212</sup> Mirrlees et al. 2011, 471.

Traditionally accepted virtues of a good income tax system are efficiency, equity, administrability and simplicity.<sup>213</sup> *Efficiency*, in general, means that a legal norm is adhered to by citizens. Complying with the legal norm may follow either from internal reasons<sup>214</sup> or external reasons, such as supervision by authorities and the threat of sanctions. Moreover, efficiency requires that the enforcement authorities actually apply the legal norm.<sup>215</sup> Efficiency in tax legislation means, therefore, that the taxation is carried out in accordance with the provisions of the relevant tax laws.<sup>216</sup> *Equity* is generally understood to require that taxation is based on the taxpayer's *ability to pay*, and that equal tax burden should be imposed on taxpayers with similar ability to pay, whereas different tax burden should be imposed on taxpayers with different ability to pay.<sup>217</sup> Net income is commonly used as an approximation of the taxpayer's ability to pay.<sup>218</sup> *Administrability* generally requires that the enforcement of tax legislation should be as economical as possible to the tax authorities and the taxpayers. In other words, tax collection should be arranged in an economical manner that induces as little compliance costs to the taxpayers as possible and as little administrative costs to the tax authorities as possible.<sup>219</sup> Finally, *simplicity* may be seen as an overarching virtue, which usually, if not taken too far, contributes to the other desired qualities.<sup>220</sup> In principle, simple systems are easier to master than complex ones, and systems that are easy to master are often less burdensome to comply with. Under common sense, simplicity contributes, for example, to efficiency (rules that are understood are easier to adhere to), equity (evaluation of the rules does not require special expertise) and administrability (compliance with the rules does not require special expertise and the rules are easy to enforce).<sup>221</sup> On the other hand, simplicity, by definition, allows for fewer variables than its antonym complexity. The amount of variables in a

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<sup>213</sup> Lederman 2007, 709; Myrsky 2013, 134–139.

<sup>214</sup> Such as moral obligations.

<sup>215</sup> See e.g. Juusela 1998, 85–94.

<sup>216</sup> Juusela 1998, 95. For tax efficiency from the economic perspective, see e.g. Zee 1995a, 25–29.

<sup>217</sup> Another commonly mentioned principle for constructing equity is the *benefits principle*, according to which taxation should be based on the 'cost' of benefits provided to the taxpayer by society. See e.g. Sneed 1965, 575–577; Zee 1995b, 30–34; Myrsky 2009, 745–749. However, the ability-to-pay principle appears to be the internationally accepted standard for the basis of a tax system. See Knuutinen 2006, 796, referring Tipke. The benefits principle seems to do better in justifying the source State's right to tax nonresidents, yet it is not uncontested. See e.g. Kaufman 1998, 184–188; Shay, Fleming & Peroni 2002, 90–91; Avi-Yonah 2014, ch. 3.2. See also Helminen 2018b, ch. 3, stating that the ability-to-pay principle and the benefits principle are relevant both in domestic settings and in cross-border settings.

<sup>218</sup> Myrsky 2009, 748.

<sup>219</sup> Myrsky 2013, 138. Cf. Adam Smith's fourth maxim of taxation. Smith 1776, 1105–1106.

<sup>220</sup> Myrsky 2013, 138 and 143.

<sup>221</sup> See also Myrsky 2013, 138.

system sets limits to how sensitive the system is to different conditions. Taken to the extreme, ‘the simplest’ tax system could be such, where a lump-sum tax is levied from everyone who happens to be in town when the tax collector comes around.<sup>222</sup> Obviously, this is not feasible in a modern society, and tax systems include a number of variables in order to account for, *inter alia*, the taxpayer’s ability to pay.<sup>223</sup>

Tax collection is the key component of enforcement of tax legislation and a tax system that is not administrable, or enforceable, is worth little or nothing.<sup>224</sup> As famously presented by Milka Casanegra de Jantscher, “tax administration is tax policy”.<sup>225</sup> Firstly, administrability is at interplay with equity. Lederman provides an illustrating example: ‘Tax A’ is the most equitable tax system in theory but is easily evaded by a significant part of taxpayers and ‘Tax B’ is slightly less equitable in theory but cannot be evaded. When the total revenue need is somewhat fixed, the inability to collect Tax A on a significant part of taxpayers requires more to be collected from the rest of the taxpayers, which eventually leads to a higher tax burden on the non-evading taxpayers than what it would be under Tax B. Therefore, Tax B will lead into a more equitable outcome, even if it was slightly less beneficial to the non-evading taxpayers in theory than Tax A.<sup>226</sup> Secondly, administrability contributes to the efficiency of a tax system. As the efficiency of tax legislation requires the taxation be carried out in line with the relevant provisions of tax legislation and as the resources of the tax authorities are not unlimited, the tax system must be administrable so that it can be enforced with the available resources. As stated above, efficiency is affected both by internal and by external reasons. According to Juusela, external reasons (supervision and sanctions) are more important than internal reasons in generating efficiency to a tax system, and supervision is more important than sanctions.<sup>227</sup> Supervision, then, is founded on structural mechanisms of the tax collection system that constrain compliance.<sup>228</sup>

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<sup>222</sup> Cf. Seligman 1895, 109.

<sup>223</sup> Simplicity is, however, probably closest to administrability: simple tax system is also easily administrable. See Lederman 2007, 709.

<sup>224</sup> Cf. Jantscher 1990, 179.

<sup>225</sup> Jantscher 1990, 179.

<sup>226</sup> See Lederman 2007, 710. See also Juusela 1998, 102–103, providing a similar example in terms of game theory.

<sup>227</sup> Juusela 1998, 116 and 121.

<sup>228</sup> Juusela 1998, 105; Lederman 2007, 697. An illustrating example may be found from the era of the Napoleonic Wars in the England. Income tax was introduced in England in 1799 to finance the Napoleonic Wars. The first income tax was evaded widely and it failed to meet the fiscal expectations. The tax was repealed already in 1802. However, it was re-enacted a year later in 1803, but this time, the income tax was schedular (instead of basing the taxation in a general return of income) and it was collected through withholding at source. The results were impressive, as the 1803

Terra & Wattel lists the preferred qualities of a dividend taxation system to be internal neutrality (neutrality between debt and equity financing), external neutrality (equal treatment of domestic and foreign dividends and shareholders) and administrative practicality.<sup>229</sup> Arguably, final withholding taxes, provisional withholding taxes as well as taxation by (self) assessment and self-payment *can* be made neutral both internally and externally if the substantial tax law is neutral and the tax system is efficient. In other words, if both debt and equity financing as well as both resident and nonresident taxpayers were subject to the same tax rules, neutrality would be achieved, provided that the tax system is efficient. Therefore, what remains to be evaluated from Terra & Wattel's list of attributes is administrative practicality, which appears to combine both efficiency and administrability (and simplicity).

Based on the above, the benefits and disadvantages of a tax collection system should be evaluated especially in the light of efficiency and administrability. In essence, an efficient and administrable tax collection system enables tax collection with reasonable costs both to the State and to the taxpayer. Therefore, withholding taxes are first evaluated from two perspectives: enforceability with reasonable costs and cost of compliance. It must also be noted that domestic tax systems often reflect the principle of ability-to-pay e.g. by basing taxation on net income.<sup>230</sup> By contrast, taxation of cross-border portfolio dividends is often based on gross income. This different treatment may be detrimental to the objectives of the internal market, thus rendering adequate a third point-of-view, namely the compatibility of final withholding taxes with net taxation. As the fourth point, final withholding tax is paid at the moment the taxable event takes place, whereas in tax systems applied in domestic settings, the taxes may be paid at a later point of time, which puts those taxpayers that are taxed in final withholding procedure into a disadvantageous position. This cash-flow disadvantage is emphasized in cases of overwithholding and withholding in the absence of tax liability. If excess taxes have been withheld in the source State, the taxpayer is usually entitled to claim for refund.<sup>231</sup> However, as is seen in chapter 3.3, the refund procedure is often lengthy.

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income tax succeeded in raising nearly as much revenue as the 1799 income tax, but at a tax rate of 5 per cent instead of 10 per cent. See Soos 1990, 122–123.

<sup>229</sup> Terra & Wattel 2019, 807.

<sup>230</sup> Other attributes reflecting the ability to pay, especially with respect to natural persons, are e.g. progressive tax rates and deductions based on personal circumstances.

<sup>231</sup> Lee & Yoon 2018, 27.

Therefore, the cash-flow disadvantage is amplified if the taxpayer must resort to the refund procedure in order to reach the correct level of taxation.

### 3.2.2 Enforceability with Reasonable Costs

#### 3.2.2.1 International enforceability

Tax authorities may always ‘kindly ask’ taxpayers to pay taxes. Such a polite request hardly leads to flattering compliance rates unless it is backed up with enforceable sanctions.<sup>232</sup> Therefore, the first question relating to enforceability is whether the State has jurisdiction to enforce its tax laws.

International enforceability relates especially to the State’s ability to enforce its legislation abroad. States do not have jurisdiction to enforce their legislation in foreign territory. In domestic settings, States enjoy fiscal sovereignty and, in principle, have always jurisdiction to enforce their tax legislation.<sup>233</sup> In cross-border settings, however, States encounter the problem of enforceability. States cannot enforce their tax legislation beyond their territory without the approval of the other State.<sup>234</sup> In order to enforce their legislation on foreign territory, States must generally resort to international treaties that provides for assistance in tax collection or information exchange.<sup>235</sup> EU States may also resort to the DAC and the RAD. Secondly, under the so-called revenue rule, States will not provide assistance to other States in collection of the final revenue claims, unless such is reciprocally agreed upon.<sup>236</sup> Within the EU, the DAC and the RAD diminish the relevance of the revenue rule, but its significance is also declining internationally, as reciprocal agreements on mutual assistance in tax matters are gaining popularity.<sup>237</sup>

In cross-border setting, tax withholding enables States to ensure they have jurisdiction to enforce tax collection. The withholding agent is typically resident in the source State of the dividends.<sup>238</sup> Therefore, the source State can impose obligations on the withholding agent and enforce them without the need to resort to the assistance of another State.<sup>239</sup> As the nonresident taxpayer is not

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<sup>232</sup> Simader 2013, 9. Cf. Juusela 1998, 111–112. See also Rohatgi 2007, 14.

<sup>233</sup> See e.g. Klabbers 2013, 91.

<sup>234</sup> See e.g. Juusela 1998, 8–9; Rohatgi 2007, 21.

<sup>235</sup> For example, the MAATM Convention and Arts. 26 and 27 OECD MC.

<sup>236</sup> See Shay, Fleming & Peroni 2002, 119–120; Rohatgi 2007, 21; Terra & Wattel 2019, 595. See also Dutta 2006, 697–724.

<sup>237</sup> Such as the MAATM Convention and Arts. 26 and 27 OECD MC.

<sup>238</sup> Withholding obligation may also be imposed on nonresident payers (extraterritorial withholding), but these situations are not common especially with respect to dividends. See Lee & Yoon 2018, 25.

<sup>239</sup> Sometimes, international cooperation may be reasonable even if there is no lack of enforcement jurisdiction. This may be the case, for example, in joint audits under Art. 12 DAC.

resident in the source State and generally does not have any physical connection to that State on which the source State's authorities could apply enforcement actions, the source State has virtually very little chances to get hold of a nonresident taxpayer.<sup>240</sup> However, by obligating the withholding agent to withhold the tax before payment of the income, the source State can retain the amount of tax within its jurisdiction.<sup>241</sup> The withholding agent has a chronological priority to the income as opposed to the taxpayer, as the income payable is first in the possession of the withholding agent before it is paid to the taxpayer.<sup>242</sup> Technically, the withholding agent is always able to withhold the tax in full from the income before paying it if the gross amount of income exceeds the amount to be withheld.<sup>243</sup> Therefore, tax withholding ensures that the taxation takes place within the source State's jurisdiction.

### **3.2.2.2 Practical enforceability**

Practical enforceability addresses the qualities that relate to the tax authorities' practical possibilities to enforce the tax legislation, i.e. to assess and collect the taxes as intended in their tax laws. Practical enforceability also requires generally that as a whole, the enforcement of tax laws costs less than what the tax yield is.<sup>244</sup> Practical enforceability is subordinate to international enforceability in the sense that a State cannot legitimately enforce its tax claims unless it has jurisdiction to enforce the tax claims in accordance with international law. Enforceability is close to the efficiency of tax legislation, as laws that cannot be enforced are hardly effective.

Studies conducted in the United States show, with respect to domestic income taxation, that misreporting of income is rarest in income classes subject to withholding, slightly more common in income classes subject to third-party information reporting, and most common in income classes

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<sup>240</sup> Simader 2013, 9.

<sup>241</sup> Cf. Simader 2013, 19.

<sup>242</sup> Martin 2012, 25.

<sup>243</sup> It seems unlikely that the amount of tax to be withheld would exceed the amount of income. Such a situation could be imagined to take place, if the withholding agent would be obliged to charge some other items (e.g. fines or other penalty payments) from the income before withholding the tax and those items would not be deductible from the tax base. Furthermore, a similar situation could take place, had the withholding agent previously failed to withhold an adequate amount of taxes, if it is allowed to withhold the remaining tax from later payments.

<sup>244</sup> Cf. Smith 1776, 1105–1106. Collecting the tax does not have to be economical from every taxpayer (e.g. tax audits where no unpaid taxes are discovered), if the system as a whole is economical and the 'non-economical' measures contribute to the system as a whole. For example, the risk of tax audit may encourage taxpayers to be compliant even if the tax audit activity in total costs more than the additional tax yields generated by the audits. Similarly, it increases equity between taxpayers, as it likely decreases the probability that impudent taxpayers evade taxes. Cf. Juusela 1998, 98–104.

subject to neither withholding nor information reporting.<sup>245</sup> Generally, it seems that tax compliance is highest where it is least dependent on the taxpayer. Although domestic income taxation and cross-border income taxation differ in many aspects, it is reasonable to suggest that also nonresident taxpayers are more likely to be compliant when there are fewer possibilities for noncompliance and when the probability of detection and consequences of noncompliance increase.<sup>246</sup> Therefore, many of the benefits that tax withholding has in, for example, domestic employment income taxation are also relevant in cross-border settings, such as taxation of outbound dividends. Although technically, tax withholding is a method for tax collection, it is also a structural device to promote tax compliance and to discourage noncompliance.<sup>247</sup> Tax withholding induces ‘voluntary’ compliance by involving a third party, the withholding agent, who generally has an incentive to withhold the taxes correctly and to transfer them to the tax authorities.<sup>248</sup> In a simple scenario, such as flat rate dividend withholding tax, the taxpayer cannot avoid paying the dividend tax because, practically, the withholding agent deducts the tax payable from the dividends and transfers it to the tax authorities. Tax withholding secures tax collection, since the tax is collected before the taxpayer has had a possibility to spend the income.<sup>249</sup>

The withholding agent’s obligation to report information to the tax authorities is likely to lead to a more accurate overall reporting of the income, as the tax authorities do not need to depend solely on the taxpayer’s own declaration. This increases the risk of detection of underreporting and, therefore, is likely to increase the compliance of the taxpayer.<sup>250</sup> The information reporting benefits

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<sup>245</sup> See e.g. Twight 1995, 386, citing U.S. House of Representatives, Committee on Ways and Means Hearings documents; Rettig 2006, 15–16.

<sup>246</sup> See also Juusela 1998, 113–121, discussing the internal and external factors affecting the compliance of taxpayers and, thus, the efficiency of taxation.

<sup>247</sup> See Soos 1990, 108 and 120–122; Lederman 2007, 697.

<sup>248</sup> Voluntary compliance may be considered a misnomer, as the withholding agent is under statutory obligation to withhold and the taxpayer cannot affect the withholding. However, the compliance is ‘voluntary’ because it does not require enforcement efforts by tax authorities. See similarly Twight 1995, 387–388, referring to political debate in the United States in the 1980s concerning expanding tax withholding to taxation of dividends and interest.

<sup>249</sup> Similarly Soos 1990, 127; Lederman 2007, 732.

<sup>250</sup> Cf. Soos 1990, 128. See also Juusela 1998, 116 and 121, according to whom effective supervision and sanctions are necessary in an efficient tax system. Third party information reporting contributes effectively to the State’s possibilities to supervision. Therefore, also the information reporting obligation contributes to the efficiency of dividend taxation.

Furthermore, the withholding agent is also likely to have more extensive, direct and up-to-date information on the taxpayer than the tax authorities. This holds true especially in simple setups, where there is no multi-layered network of intermediaries between the payer of the income and the taxpayer, yet especially publicly traded securities are commonly held through a complex intermediary network, where the withholding agent may not have any direct contact with the taxpayer. See ICG Report 2009, 8–9; Kerfs 2012, 196.

the State also in helping the tax authorities to identify taxpayers that were previously unknown to them.<sup>251</sup> In cases where the withholding agent does not necessarily know the identity of the beneficial owner of the dividend, tax withholding may encourage the taxpayer to reveal his identity to tax authorities to claim tax refund, if such would be available under domestic law, tax treaties or due to EU tax law. For example, tax authorities may not have access to the identity of beneficial owners of nominee-registered shares, but the beneficial owner may be willing to claim for refund and identify himself to the tax authorities. In this connection, tax withholding has a somewhat similar role as the *backup withholding* applied in the United States, where the taxpayer's failure to provide required information leads to an obligation to the payer of the income to withhold tax from payments that would not normally be subject to withholding.<sup>252</sup> Similarly, for example in Finland, the withholding agent must withhold the tax at the highest rate if it is not aware of the residence or corporate status of the income recipient.<sup>253</sup> This works effectively as an incentive for the taxpayer to disclose proper information.<sup>254</sup>

Administrability of withholding taxes is usually related to the fact that in general, there is a smaller number of dividend distributors than dividend recipients.<sup>255</sup> Tax authorities can more readily supervise a smaller number of income payers that are usually required to register themselves than a larger number of income recipients of whom the authorities may have no information at all.<sup>256</sup> Tax collection is also easier when it coincides with the dividend distribution, which reduces the costs of collection borne by the tax authorities.<sup>257</sup> Moreover, levying final withholding tax on gross income is prone to decrease the costs of tax collection. It does not require the State to assess the total income and expenses of the taxpayer. Final withholding systems are often based on gross income due to practical reasons. Firstly, the schedular nature of withholding taxes speak for gross-basis taxation. Withholding taxes can be seen to be targeted to the income event (object) instead of the person (taxpayer). The main consideration for the source State is identifying the outbound payments, and the taxpayer's special circumstances need not to be taken into account.<sup>258</sup> Secondly,

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<sup>251</sup> Soos 1990, 127.

<sup>252</sup> See further on backup withholding at <https://www.irs.gov/taxtopics/tc307>.

<sup>253</sup> Sec. 7(1)(4) LähdeVL.

<sup>254</sup> Karhu 2018, 224.

<sup>255</sup> More broadly, there are usually fewer income payers than income recipients.

<sup>256</sup> See Soos 1990, 127; Lee & Yoon 2018, 15–16.

<sup>257</sup> Simader 2013, 19.

<sup>258</sup> Simader 2013, 31–32.



outsourcing vigorous tax assessment obligation that net taxation could require to the withholding agent at the time of the payment of the income would put withholding agents under severe strain.<sup>259</sup> The withholding agent has first-hand information on the income it pays out, but not necessarily on the taxpayer's other income and expenses. The withholding agent could ask the taxpayer for such information, but it would not have many practical options to validate that information.<sup>260</sup> Thirdly, gross taxation is sometimes justified with the presumption that dividend income includes a large component of net gain, although this argument is difficult to accept in general.<sup>261</sup>

States often allow taxpayers to claim for refund if the taxes proved to be withheld incorrectly. Such procedure may incur remarkable costs both to the source State and the taxpayer. This is discussed in chapter 3.3.

### 3.2.3 Costs of Compliance

Final withholding is a simple system to the taxpayer. At its best, final withholding does not require any actions from the taxpayer. Large part of the compliance costs and other regulatory costs that would be borne by the taxpayer are either shifted to the withholding agent or completely abolished.<sup>262</sup> Compliance costs include the administrative burdens, such as costs related to the obligation to provide information and maintain it available.<sup>263</sup> Substantive compliance costs comprise the costs that incur from, for example, the labour costs of the staff time devoted to regulatory compliance and the costs of external service providers, if such are used.<sup>264</sup> In essence, the compliance costs arise from the obligation to pay the tax and the obligation to provide information, usually in a predefined format and language. In a tax system based on self-declaration and self-payment of taxes, the compliance costs are practically borne by the taxpayer. Shift from such a system to a withholding tax system also shifts at least some of the costs related to income reporting and tax payment to the withholding agent. In provisional withholding tax system, some

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<sup>259</sup> Simader 2013, 32.

<sup>260</sup> The withholding agent, as a private person, could not e.g. rely on the mutual assistance mechanisms in the directives or in international treaties. It could also be difficult to the taxpayer to provide information on the related expenses at the time of the payment of the income.

<sup>261</sup> See Simader 2013, 32. Also Simader disagrees with this argument and comments that it does not hold true in general even with passive income.

<sup>262</sup> Regulatory costs that taxation may incur to the taxpayer include naturally the compliance costs, but also other costs, such as financial costs (e.g. the cost of an IT system that is needed in order to comply with the compliance rules) or opportunity costs (e.g. staff time spent on tax compliance instead of income-generating activities). For an overview of regulatory costs, see e.g. OECD 2014, 11–15.

<sup>263</sup> OECD 2014, 12–13.

<sup>264</sup> OECD 2014, 17–18.

costs are still borne by the taxpayer, as the taxpayer may be required to, for example, file a tax return. In final withholding tax system, such compliance costs are mostly eliminated as there are no regular steps subsequent to withholding in the taxation process and the possible steps prior to withholding comprise mostly reporting of simple identification information. The requirement to, for example, provide identification information to the withholding agent may still incur some costs to the taxpayer.<sup>265</sup>

Although withholding taxes shift the compliance costs from the taxpayer to the withholding agent, it is fair to assume that in principle, adhering to compliance rules is less burdensome for the withholding agent than for the nonresident taxpayer. To start with, the withholding agent is typically resident in the source State, thus being able to communicate with the local tax authorities more readily. Guidelines, legislation and other materials are also usually better available in the domestic language(s) of the source State, which the nonresident taxpayer may not comprehend. Furthermore, the withholding agent, being for example a dividend-distributing company with many foreign shareholders, may be obliged to comply with the same compliance requirements with respect to each of the (nonresident) dividend recipients. The compliance costs borne by the withholding agent do not rise in direct proportion to the number of income recipients (economies of scale). Thus, concentrating the tax compliance to the withholding agent lowers the compliance costs per taxpayer and leads to lower overall compliance costs in the whole system. For a portfolio investor with relatively small investments in many jurisdictions, adhering to burdensome tax payment and information reporting requirements could incur excessive expenses. ‘Outsourcing’ the burden of compliance to the withholding agent facilitates compliance and lowers compliance costs, which probably also increases tax compliance.<sup>266</sup>

Due to the compliance costs that, for example, obligation to file a tax return would incur, final withholding may also increase equity between nonresident taxpayers receiving different amounts of income from a given source State. All other things being equal, the compliance costs incurred to the nonresident taxpayer may be considered somewhat fixed in a single State regardless of the amount of dividends. Therefore, the compliance cost for a small investor is higher in relation to

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<sup>265</sup> However, the taxpayer would likely be required to present similar and even more extensive information under anti-money laundering rules. Therefore, providing basic identification information for tax purposes does not necessarily induce any additional costs to the taxpayer.

<sup>266</sup> Cf. Soos 1990, 129; Simader 2013, 19.

the dividend income than to an institutional investor. An example illustrates the situation: State A taxes outbound dividends either by self-assessment and self-payment or provisional withholding tax. Person X, resident in State B, owns 10,000 shares in company Z and receives dividends worth of 10,000 from that company in State A. Person Y, also resident in State B, owns 1,000,000 shares in company Z and receives dividends worth of 1,000,000 from that same company in State A. Both the persons X and Y also have other similar investments in multiple States, so it is not feasible to assume that they could fulfil the compliance requirements personally without assistance. If persons X and Y are to comply diligently with the compliance requirements in State A, resorting to external consultants is probably unavoidable for them. Assuming that the consultant invoices 500 from person X on assistance with the compliance requirements and 1,000 from person Y for the same work (higher fee due to e.g. higher liability), the effective compliance cost rate for the person Y is 0.1 per cent, whereas for the person X, it is 5 per cents, fiftyfold to that of person Y.<sup>267</sup>

States often allow taxpayers to claim for refund if the taxes proved to be withheld incorrectly. Such procedure may incur remarkable costs both to the source State and the taxpayer. This is discussed in chapter 3.3.

### 3.2.4 Compatibility with Net Taxation

The ability-to-pay principle aims for taxation that is carried out in accordance with the taxpayer's relative capacity to pay taxes. Net income is usually applied as an approximation of the taxpayer's ability to pay.<sup>268</sup> Taxpayer's ability to pay may be evaluated with the help of objective and subjective net income.<sup>269</sup> The ability-to-pay principle concerns especially individuals, as companies have no 'personal and family circumstances' to be taken into account.<sup>270</sup> However, the concept is also reflected in corporate income taxation as a requirement of net income taxation, thus requiring deductibility of all business-related expenses.<sup>271</sup>

In taxation of objective net income, the (business) expenses that are incurred in generating the gross income are deducted from the tax base. Therefore, the objective net income is the taxpayer's

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<sup>267</sup> However, the income derived from State A does not necessarily resemble the overall worldwide situation of X and Y, as it is well possible that the income from State A covers only a fraction of person X's worldwide income and all of person Y's worldwide income.

<sup>268</sup> Simader 2013, 34.

<sup>269</sup> Simader 2013, 34.

<sup>270</sup> Terra & Wattel 2019, 852.

<sup>271</sup> Englisch 2014, 461.

real income.<sup>272</sup> Subjective net income takes into account not only the expenses that are incurred in generating the gross income, but also the personal expenses of the taxpayer that may derive, for example, from the taxpayer's personal and family circumstances. Generally, this is ensured by granting a default deduction or not taxing income below a certain amount.<sup>273</sup> Furthermore, subjective net income is generally 'net per taxpayer', as opposed to objective net income, which is 'net per source of income'.<sup>274</sup> Therefore, subjective net income may be perceived to follow more accurately the ability to pay of the taxpayer, whereas objective net income is simpler to calculate.

Probably the greatest disadvantage of final withholding taxes is the inherent incompatibility of tax withholding with net taxation. Tax withholding is *per se* rather difficult if not impossible to base on objective net income or subjective net income, at least as far as the assessment of net income relies on annual income, expenses and losses.<sup>275</sup> In order to withhold the tax on net basis, the deductible expenses and losses should be known before the income payment. The problem is, however, that even the taxpayer may not know all the expenses and other deductible items at that time. Even if the taxpayer could produce the information, the information is hardly verified, for example, by an auditor or foreign authorities. However, materialized or otherwise known expenses and losses could be taken into account if the taxpayer is able to provide such information. What cannot be achieved with tax withholding, though, is net taxation when the deductible expenses or losses arise after the income payment.

Further difficulties derive from the determination of deductible expenses and losses. As observed in chapter 2.2, States define the connecting factors which define the tax subjects and tax objects in that State in their domestic legislation. Correspondingly, States may define freely what items they allow to be deducted from the taxable income.<sup>276</sup> In the absence of harmonisation, Member States are similarly allowed to define freely what deductions they allow in their tax legislation, as long as the tax legislation is not discriminatory. Merely the fact that Member State A allows different

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<sup>272</sup> Simader 2013, 34.

<sup>273</sup> See Simader 2013, 35.

<sup>274</sup> *Id.*

<sup>275</sup> Traditionally, income tax assessment is based on annual tax assessment. This tradition is, however, facing changes due to phasing in of (more) real time income taxation systems in some countries (e.g. Finnish "Tulorekisteri"; UK Real Time PAYE). See <https://www.gov.uk/government/publications/real-time-information-improving-the-operation-of-pay-as-you-earn> with regard to the UK and <https://www.vero.fi/tulorekisteri/tietoa-meista/> with regard to Finland.

<sup>276</sup> Cf. Rohatgi 2007, 243–245.

expenses to be deducted on dividend income than Member State B does not entail discrimination, but it is the consequence of the non-harmonisation of dividend taxation.<sup>277</sup> Defining the deductible items separately in each State, however, may increase the costs of compliance materially.<sup>278</sup>

### 3.2.5 Cash-Flow Disadvantage

An earlier tax payment puts the taxpayer into a disadvantage, when compared to a later tax payment. Firstly, it causes a *cash-flow disadvantage (liquidity disadvantage)* to the taxpayer, since the taxpayer has less cash available, for example, for investments or operating expenses. Tax withholding may pronounce the cash-flow disadvantage in cases of overwithholding and withholding in the absence of tax liability due to the duration of the refund process.<sup>279</sup> The disadvantage is emphasized in final withholding taxes even when compared to tax collection with advance taxes or provisional withholding taxes, where the tax is also paid at least somewhat currently with the dividend distribution. Both advance taxes and provisional withholding taxes may reflect the expected net taxable income, thus rendering the difference between the paid (advance) taxes and final tax liability usually rather small.<sup>280</sup> Consequently, the possible refund is typically relatively small. As an ‘extreme’ case, a loss-making resident company may not need to pay any taxes in the first place. By contrast, final withholding tax may be levied on dividends received by a loss-making nonresident company, but the tax may be refunded later.<sup>281</sup> In general, it appears probable that nonresidents are more likely subject to taxation even in the absence of tax liability than residents, especially if that absence stems from the prohibition of source State taxation due to the fundamental freedoms. Taxation in the absence of tax liability paired with a lengthy refund procedure represents an obvious manifestation of the cash-flow disadvantage.<sup>282</sup>

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<sup>277</sup> See Terra & Wattel 2019, 48.

<sup>278</sup> For example, in Case C-342/10, *Commission v Finland*, the CJEU held that Finland must allow foreign pension institutions to make similar deductions on dividend income as is allowed for domestic pension institution. The Finnish Tax Administration interpreted the *Commission v Finland* case so that in order to be entitled to similar deductions as a domestic pension institution, the foreign pension institution must provide similar calculation as a domestic pension institution, which outlines the amount to be deducted. It is unlikely that a foreign pension institutions has such calculations readily available, which means that the foreign pension institution should incur additional compliance costs in order to be entitled to the deductions. For the Finnish Tax Administration’s guidance, see [https://www.vero.fi/en/detailed-guidance/guidance/48570/taxation\\_of\\_dividends\\_received\\_by\\_forei/](https://www.vero.fi/en/detailed-guidance/guidance/48570/taxation_of_dividends_received_by_forei/).

<sup>279</sup> This applies both in domestic and cross-border settings, although the refund procedure may be less time consuming in domestic settings, thus making the problem also smaller. See also Äimä 2009, 162.

<sup>280</sup> See Simader 2013, 10.

<sup>281</sup> Cf. C-575/17, *Sofina*, paras. 28 and 34.

<sup>282</sup> See also Simader 2013, 40–41.

Secondly, the net present value of earlier tax payment is higher than that of a later tax payment even if the amount of tax is nominally equal in both payments, meaning that nominally equal but earlier tax payment generates an effectively higher tax amount.<sup>283</sup> However, as dividend taxation is usually based on tax withholding also in domestic settings or alternatively, if the taxpayer is a company, the taxpayer is obliged to pay advance taxes, there is usually no material difference in the time of tax payment that would cause material disadvantage to nonresident taxpayers.<sup>284</sup> Even if there was a material difference in the time of tax payment that would increase the effective tax amount, it is not, *per se*, more problematic than any other reason that causes differences in the effective tax amount between residents and nonresidents, such as application of different tax rates and tax bases.<sup>285</sup>

### 3.3 Withholding Tax Refund

Tax withholding may be executed on net income by adjusting the tax assessment procedure prior and subsequent to withholding, as is done in provisional withholding tax systems. In final withholding, somewhat similar results may be achieved with the refund procedure. States often allow taxpayers to claim for refund if the withholding agent has withheld taxes in excess amount.<sup>286</sup> Excessive tax withholding may result from multiple reasons. Firstly, the withholding agent may be obliged to withhold the tax unless there is an explicit waiver of the withholding obligation.<sup>287</sup> Secondly, the withholding agent may mitigate its own risk position by rather overwithholding than underwithholding. The withholding obligation may include strict liability to the withholding agent regarding the taxes payable, and the withholding agent is often in the position of being effectively

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<sup>283</sup> Advancing tax payments increases the effective amount of tax, since under the time-value of money theory, the value of money that is available at the present time is worth more than the same nominal sum in the future. López-Díaz, López-Díaz & Martínez-Fernández 2018, 75. Cf. also Simader 2013, 9–10. On the other hand, the time-value of money can (theoretically) also be negative if the interest rates are negative. See e.g. <https://blogs.imf.org/2019/02/05/cashing-in-how-to-make-negative-interest-rates-work/>.

<sup>284</sup> See Simader 2013, 9. See also *infra* ch. 4.1. By contrast, in refund settings, the difference in the effective amount of tax may be more relevant due to the general duration of tax refund processes, unless the refund bears interest, which mitigates the difference in the effective amount of tax. See Simader 2013, 14.

<sup>285</sup> From the EU tax law perspective, as long as the final tax burden, which takes into account also the taxation (and elimination of double taxation) in the taxpayer's State of residence, is not more burdensome than the taxation of taxpayers resident in the source State, the increase in the amount of tax due to the earlier tax payment does not incur discrimination. See *supra* ch. 2.3.2.2. See also Twight 1995, 373–374, summarizing the discussion in the US concerning the introduction of a broad-based income tax withholding system in the 1940s. According to Twight, US Treasury officials repeatedly testified that income tax withholding does not represent an additional tax burden, which was, at the very least, misleading, as it neglected the concept of net present value.

<sup>286</sup> Lee & Yoon 2018, 27.

<sup>287</sup> Simader 2013, 13.

a secondary or supplementary taxpayer with regard to the tax it is obliged to withhold.<sup>288</sup> After the withholding agent has paid the income to the income recipient, it may not be practically or even legally possible to the State to claim the tax from the nonresident taxpayer if the withheld tax appears to be inadequate.<sup>289</sup> It is imaginable that claiming the tax could be even more difficult for the withholding agent.<sup>290</sup> Therefore, the withholding agent may be inclined rather to overwithhold for safety in accordance with the ‘worst-case scenario’ than risk underwithholding.<sup>291</sup> Thirdly, the withholding agent may also withhold excess tax by error.

The refund procedure may lead to a major increase in compliance costs and especially the regular need to resort to the refund procedure diminishes the economy in tax collection also in the State’s point of view.<sup>292</sup> Furthermore, as a ‘special’ procedure, it tends to be burdensome and expensive, and it tends to take a long time. The processing time for EU law based withholding tax refund claims tend to be between two and three years in Finland and the processing time in other Member States is likely to be even longer.<sup>293</sup> Such a procedure puts final withholding taxes in disadvantage when compared to a system where the tax would be levied (more) correctly.<sup>294</sup> The refund

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<sup>288</sup> Lee & Yoon 2018, 27.

<sup>289</sup> *Id.*

<sup>290</sup> The withholding agent cannot generally act as an authority and, therefore, it has a more limited toolkit internationally. It cannot, for example, resort to the mutual assistance procedures provided for in the DAC and the RAD or in international treaties. Hypothetically, the withholding agent could enforce the tax claim to other assets that belong to the taxpayer and are in the withholding agent’s possession (e.g. bank account, if the withholding agent is a bank) or future payments (e.g. future dividends payable to the same taxpayer). However, such practice could face practical and legal constraints. For example in Finland, the withholding agent is allowed to increase the amount to be withheld from the same taxpayer on payments made later on the same calendar year, if the withholding agent has withheld an inadequate amount of tax on that year. The maximum increase is 10 per cent unless the taxpayer consents for more. See Sec. 8 LähdeVL and Sec. 19 EPL. See also Nykänen 2015, 212. With e.g. quarterly dividend distributions, this may give some leeway to the withholding agent, but even then, the relevance is probably rather marginal, as a non-cooperative shareholder could always e.g. sell the shares. The provision seems to be more relevant with regard to employment income. Cf. Kansainvälisen verotuksen käsikirja 2015, 118.

<sup>291</sup> Lee & Yoon 2018, 27.

<sup>292</sup> Simader 2013, 13.

<sup>293</sup> This is according to the author’s experience. For example in Finland, the refund applications incur great administrative burden to the tax authorities, and the need to resort to refund procedure is often recurring to the taxpayer. See Valtiovarainministeriö 2018, 98.

The processing time of tax treaty based refund claims appears to be shorter, but even still, whereas some Member States can handle tax treaty based reclaims within weeks, the same procedure takes several years in other Member States. See T-BAG Group Report 2013, 15; Commission 2017a, 10.

<sup>294</sup> Simader 2013, 36. In comparison, the estimated processing time for claims for adjustment in corporate income taxation is nine months in Finland, meaning that even a domestic ‘special’ procedure is likely to be materially quicker than the withholding tax refund procedure. See <https://www.vero.fi/en/businesses-and-corporations/file-and-pay/processing-times-for-returns-and-applications/>.

procedure also increases the cash-flow disadvantage when compared to provisional withholding procedure, where the taxpayer does not need to resort to additional claims for refund that often.



## 4 Does Final Withholding Violate the Fundamental Freedoms?

### 4.1 Domestic Taxation of Portfolio Dividends

States apply different systems for taxing corporate profits. In domestic settings, the most common system is schedular (semi-classical) system, where dividend income is distinguished from other income types and economic double taxation is eliminated or alleviated at least to some extent.<sup>295</sup>

A vast majority of the EU States levy withholding tax on portfolio dividends paid to nonresidents under their domestic legislation.<sup>296</sup> Tax treaties generally allow the source State to levy source tax on dividends paid to nonresidents, yet the rates may be reduced from the ones that would be applied under domestic legislation of the source State. The source State typically levies the tax in final withholding procedure. The State of residence is also allowed to levy tax on the dividends, but it is also generally obliged to eliminate juridical double taxation either by credit or exemption method.<sup>297</sup> In the absence of a tax treaty, States may also eliminate juridical double taxation of their residents unilaterally.<sup>298</sup>

In order to analyse whether final withholding taxation of outbound dividends incurs different treatment, a brief outlook must be made on the practices that Member States apply in taxation of

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<sup>295</sup> Helminen 2010a, 17; Terra & Wattel 2019, 801. Schedular systems alleviate economic double taxation e.g. by applying tax rates that are lower than the general income tax rate or by applying smaller tax base. For example, Finland taxes dividends of publicly listed companies received by resident natural persons at rate of 30 per cent (or 34 per cent), which is the general tax rate for capital income, but the tax base is only 85 per cent of the total amount of dividends. As a result, the tax is lower than income tax, at least in the higher income brackets (yet income tax may be lower than the effective dividend tax on low income brackets due to steep progression of the income tax).

Final withholding taxes are often schedular. Besides the schedular system, dividend taxation may also be based on the classical system, where the corporate profits are first taxed in the hands of the company and then in the hands of the shareholder at the regular tax rate. Economic double taxation is not mitigated at all. Furthermore, States may also apply an imputation system, where the taxes paid by the dividend distributing company on the profits out of which the dividends are paid may be credited in the dividend recipient's income taxation either partially or in full. Such systems are sophisticated in eliminating economic double taxation, but States are reluctant to apply them in cross-border settings due to the potential imbalance that could result from allowing credit on foreign-source dividends or outbound dividends. After such cases as the CJEU's Case C-319/02, *Manninen* and the EFTA Court's Case E-1/04, *Fokus Bank ASA*, which required Member States to extend imputation credit also to cross-border settings, EU States gave up their imputation systems and mostly changed them to schedular ones. See Terra & Wattel 2019, 800–807.

<sup>296</sup> A few Member States, such as Cyprus and the United Kingdom, do not levy withholding tax on dividends. See generally the respective chapters in PwC 2018.

<sup>297</sup> See e.g. Art. 10 OECD MC. Exceptionally, the tax treaty between the United Kingdom and Finland allocates, as a main rule, taxing rights solely to the residence State of the taxpayer. See Art. 11(1) of the UK/Finland Double Taxation Convention (as amended).

<sup>298</sup> For example, Finland eliminates juridical double taxation also in the absence of a tax treaty under the Act on the Elimination of International Double Taxation (Laki kansainvälisen kaksinkertaisen verotuksen poistamisesta, 1552/1995).

portfolio dividends in domestic settings. The purpose of the outlook is to provide support for the general assumptions used in the analysis.<sup>299</sup>

With respect to the tax collection method that is applied in domestic settings, a further comparison of 10 Member States is made.<sup>300</sup> The taxability of the dividends is not reviewed, but only the tax collection method with which the dividend tax, if any, is collected.<sup>301</sup> States apply different methods for collecting dividend taxes in domestic settings. If the dividend recipient is a natural person, collecting dividend taxes through tax withholding appears to be the prevalent method.<sup>302</sup> The practices vary more with regard to the finality of the withholding taxes. The dividend withholding tax is often provisional and serves essentially as an advance payment of tax that is credited against total tax liability assessed in final assessment or refunded, if the taxes withheld exceed the total tax liability.<sup>303</sup> Denmark and Luxembourg apply final withholding if the amount of dividends does not exceed a certain threshold, and provisional withholding in other cases.<sup>304</sup> The withholding tax may also be final for individuals, as in Germany.<sup>305</sup>

With the dividend recipient being a company, the practices vary more. Some States require the dividend distributor to withhold dividend tax on intercompany portfolio dividends, whereas other States do not require withholding if the dividends are paid to a resident company.<sup>306</sup> If tax withholding is applied, the withheld tax is not the final tax, but can be credited against annual tax

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<sup>299</sup> Naturally, when it comes to applying the fundamental freedoms in a concrete case, all the relevant facts in that individual case must be taken into account. *Cf.* Lenaerts 2012, 4 and 8–9; Pistone & Szudoczky 2018, 36–38.

<sup>300</sup> Austria, Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands, Sweden and the United Kingdom. It is acknowledged that these States may not necessarily form a comprehensive outlook on the practices applied in the EU as no ‘eastern’ Member States are included. However, in the author’s view, these States are (mostly) significant source States of dividend income in the EU.

<sup>301</sup> For example, Finland taxes intercompany dividends in domestic settings only, if the dividend is distributed by a publicly quoted company and the dividend recipient is not a publicly quoted company, which holds less than 10 per cent of the equity in the distributing company. See PwC 2018, ch. Finland.

<sup>302</sup> Austria, Denmark, Finland, France, Germany, Italy, Luxembourg, the Netherlands and Sweden apply tax withholding in collection of dividend tax paid to individuals. Exceptionally, the United Kingdom does not apply tax withholding. See the respective chapters in PwC 2018 and the branch reports in IFA 2018.

<sup>303</sup> For example, in Austria, Finland, the Netherlands and Sweden. See the respective chapters in PwC 2018 and the branch reports in IFA 2018.

<sup>304</sup> In Denmark, the dividend withholding tax is final for individuals, whose share income does not exceed DKK 51,700 and provisional for individuals above that limit. See Bundgaard 2018, 195. In Luxembourg, final withholding is applied on individual dividend recipients, if the annual amount of dividends does not exceed EUR 1,500, yet exceptions apply to this rule. See Adam & Lyaudet 2018, 412.

<sup>305</sup> Martini & Valta 2018, 258–259.

<sup>306</sup> For example, Austria, Denmark, Germany, Luxembourg and the Netherlands apply withholding also to intercompany dividends. Finland, France, Italy, Sweden and the United Kingdom do not require withholding, if the dividend recipient is a resident company. See the respective chapters in PwC 2018 and the branch reports in IFA 2018.

liability or, if excess taxes have been withheld, refunded.<sup>307</sup> Companies are mostly required to pay advance taxes in, for example, monthly<sup>308</sup>, quarterly<sup>309</sup> or biannual<sup>310</sup> instalments.

Despite the differences, two broad common qualities are found. Firstly, the taxation of portfolio dividends mostly appears to resemble taxation of net income or the taxpayer's ability to pay for both corporate and individual taxpayers in domestic settings. Noting the few exceptions, dividend taxation is generally integrated to the general income taxation of the taxpayer or the dividend taxation is provisional.<sup>311</sup> Secondly, the dividend tax is paid somewhat currently, as the tax is either collected through withholding at the moment of dividend distribution or the (corporate) recipient is required to pay rather frequent advance taxes.

## 4.2 Admissibility of Final Withholding

### 4.2.1 Introduction

Nonresidents that are taxed in final withholding procedure may face generally two kinds of different treatment when compared to resident taxpayers: the final amount of tax may be different and the tax collection method may be different.<sup>312</sup> Different tax treatment in itself is not against the fundamental freedoms, but treating nonresident taxpayers less beneficially than comparable<sup>313</sup> resident taxpayers may be prohibited by the fundamental freedoms. Although the CJEU holds that residents and nonresidents are not comparable in principle,<sup>314</sup> they become comparable once the source State imposes tax liability to the resident and nonresident dividend recipients alike.<sup>315</sup> Different tax treatment may be justified, if there is an overriding reason of public interest that speaks for treating residents and nonresidents differently. Even then, the measure causing the different treatment, namely the final withholding taxation of outbound dividends, must be

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<sup>307</sup> See the respective chapters in PwC 2018 and the branch reports in IFA 2018.

<sup>308</sup> Finland and Sweden. See the respective chapters in PwC 2018.

<sup>309</sup> Austria, France, Germany, Luxembourg and the United Kingdom (companies with taxable profit in excess of GBP 1.5 million; smaller companies pay tax annually). See the respective chapters in PwC 2018.

<sup>310</sup> Denmark and Italy. See the respective chapters in PwC 2018.

<sup>311</sup> According to Vanistendael, ability to pay is among the general principles of EU law, although it has no clear legal basis in the Treaties. See Vanistendael 2014, 121.

<sup>312</sup> Simader 2013, 40.

<sup>313</sup> Comparability will not be discussed extensively here. An extensive analysis may be found, for example, in Simader 2013, 127–180.

<sup>314</sup> C-279/93, *Schumacker*, para. 31; C-282/07, *Truck Center*, para. 38. With respect to the free movement of capital, this is explicitly stated in Art. 65(1)(a) TFEU.

<sup>315</sup> See e.g. C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, para. 68; C-170/05, *Denkavit*, paras. 34–35; C-379/05, *Amurta*, para. 38; Joined Cases C-10/14, C-14/14 and C-17/14, *Miljoen and Others*, para. 67; C-575/17, *Sofina*, para. 47.

necessary and suitable for achieving the objective with which it is justified.<sup>316</sup> All relevant and applicable legislation must be considered when the fundamental freedoms are applied, and therefore, also the existing secondary legislation, especially the DAC and the RAD, must be taken into account when the admissibility of final withholding taxes is evaluated.

The CJEU has accepted multiple justifications for different treatment of residents and nonresidents in taxation of cross-border dividends under its rule of reason doctrine.<sup>317</sup> Respectively, it has consistently rejected certain justifications.<sup>318</sup> According to Terra & Wattel, all justifications for treating residents and nonresidents differently boil down to the need to protect tax base integrity. Member States need to be able to safeguard their right to tax economic activity carried out within their territory and value increases recorded in their jurisdiction.<sup>319</sup> The accepted and rejected justifications as well as proportionality have been discussed extensively in literature, and it is not relevant to have an extensive look at them within the scope of this study.<sup>320</sup>

#### 4.2.2 Tax Amount

The total amount of taxes paid on outbound dividends in the source State may differ from the total amount of taxes a comparable domestic dividend recipient would pay. If the nonresident taxpayer is due more taxes in the source State than the resident taxpayer would be, the source State, in principle, discriminates the nonresident. There are some typical reasons that may cause different treatment with respect to the tax amount. The different tax amount may stem from the fact that the source State eliminates juridical or economic double taxation in domestic settings but does not allow such relief in cross-border settings.<sup>321</sup> Obviously, the tax rate and tax base that is applied

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<sup>316</sup> See *supra* ch. 2.3.2.2.

<sup>317</sup> Such as effectiveness of fiscal supervision and tax collection, anti-abuse and prevention of double deduction of losses, cohesion of tax system, balanced allocation of taxing rights, and territoriality principle. See in short Helminen 2018a, 133.

<sup>318</sup> For example, administrative burden, loss of tax revenues and other reasons of a purely economic nature, and lack of harmonisation. See Helminen 2018a, 133–134 and the cited case law.

<sup>319</sup> Terra & Wattel 2019, 631. Terra & Wattel continues: “All of the ostensibly different mandatory requirements of public interest the Court has accepted as justifying differential tax treatment of cross-border positions – – [such as]: the need (i) to curb fraud and abuse and the needs for (ii) fiscal coherence, (iii) fiscal territoriality, (iv) a balanced allocation of taxing rights, (v) effective fiscal supervision and (vi) fighting the use of tax havens – – effectively come down to the need to protect tax base integrity. The need for effective fiscal supervision is the procedural counterpart of the need to substantively preserve base integrity: supervision is needed to effectuate base integrity.” Terra & Wattel 2019, 631.

<sup>320</sup> See e.g. Simader 2013, 181–287; Helminen 2018a, 132–150; Lazarov, 86–100.

<sup>321</sup> Terra & Wattel 2019, 808. Concerning economic double taxation, see C-319/02, *Manninen*; C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*; C-284/06, *Burda*; EFTA Court Case E1-04, *Fokus Bank ASA*. See also Terra & Wattel 2019, 800–807 and 809.

may also be different. Furthermore, the taxation of portfolio dividends is usually based on gross dividends in cross-border settings, whereas in domestic settings, the taxation is usually somewhat based on net income.<sup>322</sup> Outbound dividends may be subject to tax in the source State even if the dividend recipient is making losses and the source State would not levy tax on loss-making domestic dividend recipient.<sup>323</sup>

As observed in chapter 2.3.2.2, discriminative taxation in the source State may be ‘justified’, if the taxpayer’s State of residence neutralises the discriminative tax treatment due to a tax treaty obligation. However, it may be argued that neutralisation should not be considered as a ‘justification’, because the neutralisation actually removes the unfavourable treatment that was to be justified in the first place.<sup>324</sup> The State of residence does not always neutralise the discriminative tax treatment arising in the source State. States are generally reluctant to grant credit that exceeds the taxpayer’s tax liability attributable to that State. Therefore, discriminative taxation in the source State cannot usually be neutralised in the State of residence, if the taxpayer is not in a taxpaying position there or pays only a relatively small amount of taxes. The absence of tax liability in the source State may be caused by the fact that the dividend recipient is, for example, generally tax exempt<sup>325</sup> or loss-making.<sup>326</sup> It follows clearly from the CJEU’s case law that although nonresident taxpayers may be treated differently than resident taxpayers, the treatment of nonresidents may not be less favourable in the source State than the treatment of residents, unless the source State ensures (by way of a tax treaty) that the discrimination is neutralised.<sup>327</sup> Consequently, the effective tax burden of a nonresident taxpayer shall not generally be higher than that of a resident taxpayer.<sup>328</sup> In particular, the source State may not levy final withholding tax on dividends in cross-border settings, if no tax would be levied in a similar domestic setting.<sup>329</sup>

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<sup>322</sup> See *supra* ch. 3.1.1 and ch. 4.1, respectively.

<sup>323</sup> Such a situation was present in the recent Case C-575/17, *Sofina*.

<sup>324</sup> Simader 2013, 262.

<sup>325</sup> See e.g. C-303/07, *Aberdeen Property Fininvest Alpha Oy*.

<sup>326</sup> Such as in C-575/17, *Sofina*.

<sup>327</sup> Simader 2013, 249–250; Terra & Wattel 2019, 824. Unilateral tax credit granted by the State of residence is not capable of ‘justifying’ discriminative taxation in the source State. A tax treaty concluded by the source State and the State of residence is included in the legal system of the source State. By concluding a tax treaty that provides for the neutralisation of discriminative tax treatment, the source State ensures that the discriminative taxation is neutralised. By contrast, unilateral tax credit is not ensured by the source State. See Simader 2013, 250.

<sup>328</sup> Terra & Wattel 2019, 825–826.

<sup>329</sup> See e.g. C-303/07, *Aberdeen Property Fininvest Alpha Oy*; C-342/10, *Commission v Finland*; Joined Cases C-338/11–C-347/11, *Santander Asset Management SGIC and Others*; C-575/17, *Sofina*.

Furthermore, although the CJEU recognizes the difference between worldwide taxation of residents and limited taxation of nonresidents,<sup>330</sup> the source State must allow nonresident taxpayers to deduct expenses that are related to generating the income in the source State, if resident taxpayers would be entitled to similar deductions and if the gross-basis taxation of nonresidents would lead to a higher tax burden than net-basis taxation of residents.<sup>331</sup> Only expenses that are directly linked to the actual payment of outbound dividends must be deductible in the source State for the nonresident taxpayer similarly as they would be for a resident taxpayer.<sup>332</sup> As the CJEU's assumption appears to be that the taxpayer's State of residence considers the taxpayer's personal circumstances on a worldwide basis, including the ability to pay, and the source State considers only the isolated piece of income that is sourced in that State, it is not surprising that a distinction is made between person-related and income-related expenses.<sup>333</sup> Person-related expenses are to be deductible in the State of residence (Schumacker<sup>334</sup> rule) and income-related, i.e. the expenses necessary for generating the income, are to be deductible in the source State (Gerritse<sup>335</sup> rule).<sup>336</sup>

It seems quite clear that, as a main rule, Member States must ensure that nonresident dividend recipients do not pay more taxes on the same income than comparable resident dividend recipients would.<sup>337</sup> However, in some cases different tax amount may have been justified by the principle of territoriality, under which only expenses that are directly connected to the source State are to be deductible in the source State.<sup>338</sup> In essence, Member States are allowed to require that taxation be

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<sup>330</sup> See C-234/01, *Gerritse*, para. 43; C-282/07, *Truck Center*, para. 42; Terra & Wattel 2019, 813.

<sup>331</sup> See e.g. C-265/04, *Bouanich*, paras. 40–41, 43 and 56; Joined Cases C-10/14, C-14/14 and C-17/14, *Miljoen and Others*, paras. 57–59, 61 and 90; C-18/15, *Brisal*, paras. 23 and 44–47; Terra & Wattel 2019, 826. See similarly Helminen 2010b, 404.

<sup>332</sup> Joined Cases C-10/14, C-14/14 and C-17/14, *Miljoen and Others*, para. 58; Terra & Wattel 2019, 855–856. Concerning interest payments, see also C-18/15, *Brisal*, para. 46.

<sup>333</sup> C-234/01, *Gerritse*, para. 43; Terra & Wattel 2019, 861. Cf. also Terra & Wattel 2019, 813.

<sup>334</sup> C-279/93, *Schumacker*. In the *Schumacker* case, the Court argued that the taxpayer's State of residence is usually better positioned to determine the taxpayer's personal ability to pay tax, because the taxpayer's aggregate income and personal and family circumstances are usually easier to assess in the State of residence (para. 32). Therefore, as a rule, the source State need not allow nonresidents to deduct person-related expenses (para. 34).

<sup>335</sup> C-234/01, *Gerritse*. According to the *Gerritse* case, residents and nonresidents are comparable with respect to business expenses that are directly linked to the activity that generates the income in the source State, and refusing to allow nonresidents to deduct such expenses that residents are allowed to deduct constitutes indirect discrimination on grounds of nationality (paras. 27–28).

<sup>336</sup> Terra & Wattel 2019, 861.

<sup>337</sup> Similarly Terra & Wattel 2019, 828.

<sup>338</sup> Simader 2013, 203–204; Helminen 2018a, 146–147. However, the Case C-575/17, *Sofina* seems to depart from the principle of territoriality, as in that case, the CJEU required that the source State must grant a loss-making nonresident taxpayer deferral of the dividend taxation, if similar benefit is granted to domestic dividend recipients (para. 79). See Willems 2019, 104.

connected with the territory where the taxpayer performs the economic activity generating the income, expenses or losses.<sup>339</sup>

#### 4.2.3 Tax Collection Method

Keeping in mind the observation that final withholding is not usually applied in domestic settings,<sup>340</sup> levying final withholding tax in cross-border settings usually means that nonresident dividend recipients are treated differently than resident dividend recipients. Even if the effective tax amount that the nonresident dividend recipient must pay is not more than what a comparable resident dividend recipient would be due, the different tax collection method still leads to differences in the procedural burden and costs of compliance as well as in different time of tax payment.<sup>341</sup> As observed in chapter 3.2, final withholding is a simple tax collection method from the taxpayer's perspective and requires minimal or no actions from the taxpayer. Therefore, it is unlikely that final withholding would be less beneficial to a nonresident taxpayer with regard to the procedural burden and costs of compliance than provisional withholding or taxation by assessment, which are usually applied in domestic situations and which often require participation of the taxpayer.

The Case C-282/07, *Truck Center* shows that Member States are free to apply different tax collection methods on residents and nonresidents and are thus free to collect taxes on nonresidents through final withholding taxes, whereas residents are taxed, for example, through comprehensive assessment.<sup>342</sup> In later judgements, the CJEU has clarified the message of the *Truck Center* judgement by requiring that the different treatment is limited merely to applying a different tax collection method and that the taxation of residents may not be more advantageous than that of nonresidents.<sup>343</sup> Furthermore, the timing of the tax payment may not disfavour nonresidents or the difference must be negligible. As observed in chapter 4.1, States usually collect dividend taxes through (provisional) withholding also in domestic settings or, with the recipient being a company,

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<sup>339</sup> This resembles the source State entitlement principle, underlying also, for example, the tax treaties based on the OECD MC. See Terra & Wattel 2019, 688–689. See also C-379/05, *Amurta*, para. 58.

According to Terra & Wattel, the territoriality principle and the balanced allocation of taxing rights are identical and, together with the concept of fiscal coherence, all aim at allowing the source State to defend its right to exercise its taxing powers on activities carried on within its territory. See Terra & Wattel 2019, 680–690.

<sup>340</sup> See *supra* ch. 4.1.

<sup>341</sup> It is apparent that different treatment caused by the tax collection method cannot be neutralised by the State of residence. See Simader 2013, 287.

<sup>342</sup> C-282/07, *Truck Center*, para. 41.

<sup>343</sup> See Willems 2019, 106, and the cited case law.

require regular advance tax payments. In the ‘basic scenario’ where the dividend recipient is profitable and the source State does not overwithhold taxes or withhold taxes in the absence of tax liability,<sup>344</sup> final tax withholding at the moment of the dividend distribution does not usually constitute material difference in the timing of the tax payment.<sup>345</sup> It appears that minor cash-flow disadvantages that arise within the same tax year because of application of different tax collection methods do not infringe the fundamental freedoms.<sup>346</sup>

The timing difference and, hence, the cash-flow disadvantage may grow material, if the source State allows deferral of the tax payment for resident taxpayers in certain situations. For example, the source State may allow a loss-making resident taxpayer to defer the tax payment until it turns profitable again, but refrains from granting a similar deferral to a nonresident taxpayer. This situation was at hand in the *Sofina*<sup>347</sup> case, according to which the source State must grant a loss-making nonresident taxpayer deferral of the dividend taxation, if similar benefit is granted to domestic dividend recipients.<sup>348</sup> Granting deferral does not mean that the source State would waive its taxation rights, but indicates that the source State must consider foreign losses and refrain from levying taxes on loss-making nonresident dividend recipients, if it would do so in domestic settings.<sup>349</sup> Once the nonresident taxpayer returns to profitability, the source State could subject the dividends to tax similarly as in domestic settings.<sup>350</sup> If the nonresident taxpayer would never turn profitable, the deferral of taxation would effectively lead to tax exemption in the source State. However, this does not justify different treatment, as reduction in tax revenue is not considered as a valid justification by the CJEU.<sup>351</sup>

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<sup>344</sup> Overwithholding may be caused by, for example, withholding more taxes than is allowed in an applicable tax treaty or withholding taxes when such is prohibited by EU tax law.

<sup>345</sup> The CJEU seems to draw an analogy between withholding taxes and advance taxes in Case C-282/07, *Truck Center*, para. 49: “the difference in treatment resulting from [withholding tax] – – does not necessarily procure and advantage for resident recipient companies because, firstly, – – those companies are obliged to make advance payments of corporation tax.” See also Terra & Wattel 2019, 812.

<sup>346</sup> C-252/14, *Pensioenfond Metaal en Techniek*, para. 41; C-575/17, *Sofina*, para. 30. See similarly Willems 2019, 103.

<sup>347</sup> C-575/17, *Sofina*.

<sup>348</sup> C-575/17, *Sofina*, para. 79.

<sup>349</sup> C-575/17, *Sofina*, para. 59.

<sup>350</sup> *Id.*

<sup>351</sup> C-575/17, *Sofina*, paras. 60–61.



#### 4.2.4 Rejected Justifications

Some rejected justification are especially interesting in the context of levying withholding taxes in the internal markets. To begin with, the CJEU has repeatedly rejected the justifications that are purely of economic nature and consequently, loss of tax revenue does not justify discrimination.<sup>352</sup> Administrative difficulties are not a justified reason for discrimination, either.<sup>353</sup> Administrability of a tax system is closely related to the accepted justifications of effectiveness of fiscal supervision and the effective collection of taxes: an administrable tax system is efficient at reasonable cost.<sup>354</sup> The difference of effective fiscal supervision and tax collection, on one hand, and administrability, on the other hand, is that the latter disregards the availability of mutual assistance procedures, because they are burdensome to administer.<sup>355</sup> Administrative burdens could be overcome by allocating more resources to the tax authorities. As the CJEU has indicated in rejecting justifications that are of economic nature, it is not surprising that justifications that are based on the low costs of tax collection are not accepted either; after all, both gross tax revenue and costs of collection affect the State's net tax revenue.

Effective fiscal supervision and tax collection are accepted as justifications only if there is no less restrictive means to ensure tax collection or fiscal supervision.<sup>356</sup> Effective mutual assistance procedures that are available for Member States, such as the DAC and the RAD, render effective tax collection and fiscal supervision generally inadmissible in intra-EU situations, because Member States can ensure effective tax collection and fiscal supervision in a less restrictive way with the help of the DAC and the RAD.<sup>357</sup> In the *Sofina*<sup>358</sup> case, the CJEU held that although the effective collection of tax has been considered capable of justifying restrictions on fundamental freedoms<sup>359</sup> and tax withholding has been considered proportionate to ensure that objective,<sup>360</sup> the

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<sup>352</sup> See e.g. C-35/98 *Verkooijen*, paras. 47–48; C-575/17, *Sofina*, para. 61. See also Simader 2013, 184–185; Helminen 2018a, 133. For example in Case C-436/00, *X and Y*, para. 50, the CJEU held that potential loss of tax revenue is a purely economic justification and cannot therefore be accepted.

<sup>353</sup> C-326/12, *van Caster*, para. 56; Terra & Wattel 2019, 863.

<sup>354</sup> See *supra* ch. 3.2.1.

<sup>355</sup> Cf. C-326/12, *van Caster*, paras. 48–56. See also Simader 2013, 189–190.

<sup>356</sup> Helminen 2018a, 135.

<sup>357</sup> Helminen 2018a, 135; Lazarov 2018, 91–93. According to Pistone & Szudoczky, the increasing efficiency and availability of international instruments for exchange of information are likely to make effectiveness of fiscal supervision obsolete even in relations between EU and third countries. See Pistone & Szudoczky 2018, 58–59.

<sup>358</sup> C-575/17, *Sofina*.

<sup>359</sup> C-575/17, *Sofina*, para. 67, with reference to C-18/15, *Brisal*, para. 39.

<sup>360</sup> C-575/17, *Sofina*, para. 68, with reference to C-498/10, *X*, para. 39.

source State cannot refrain from granting similar benefit of deferral to loss-making nonresident companies as it would grant to loss-making resident companies. The Court reasons this most prominently by stating, firstly, that the fundamental freedoms do not preclude the source State from requiring the nonresident taxpayer to provide relevant evidence that enables the source State to determine, if the nonresident taxpayer meets the conditions for tax deferral.<sup>361</sup> Secondly, the mutual assistance mechanisms provided in the DAC and the RAD provide the source State with tools to ascertain the information provided by the nonresident taxpayer and to secure the tax collection from the nonresident taxpayer.<sup>362</sup>

Lastly, the CJEU has repeatedly held that unfavourable tax treatment of nonresidents cannot be justified by other tax advantages.<sup>363</sup> Therefore, the fact that final withholding usually benefits the nonresident taxpayer due to the simplicity and thus lower compliance costs<sup>364</sup> cannot justify the potential disadvantages, such as a higher tax amount or a material cash-flow disadvantage.

### 4.3 Conclusions

The case law of the CJEU allows for a rather straightforward conclusion that in principle, taxing nonresident dividend recipients through final withholding procedure, whereas resident dividend recipients are taxed through some other procedure, does not infringe the fundamental freedoms.<sup>365</sup> The collection mechanism of an otherwise indiscriminate tax does not incur discrimination.<sup>366</sup> Furthermore, the CJEU's standing that with regard to tax collection system, residents and nonresidents are, as a rule, not comparable is logical.<sup>367</sup> It is not credible to assume that a nonresident recipient of portfolio dividends be familiar with the compliance requirements and the language of the source State. Nonresident and resident taxpayers are not generally comparable with respect to their personal ability to adhere to the requirements of the source State. Therefore,

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<sup>361</sup> C-575/17, *Sofina*, para. 72.

<sup>362</sup> C-575/17, *Sofina*, paras. 73–76.

<sup>363</sup> See C-182/06, *Lakebrink and Peters-Lakebrink*, para. 24 and the cited case law.

<sup>364</sup> See *supra* ch. 3.2.3.

<sup>365</sup> Recently, the CJEU also confirmed the admissibility of withholding taxes from the withholding agent's perspective. See *supra* ch. 3.1.2 and the Joined Cases C-115/16, C-118/16, C-119/16 and C-299/16, *N Luxembourg 1 and Others v Skatteministeriet*, paras. 159–160.

<sup>366</sup> Terra & Wattel 2019, 825.

<sup>367</sup> See e.g. C-282/07, *Truck Center*, para. 38.

applying identical rules to resident and nonresident taxpayers could even violate the fundamental freedoms, if the rules are such that they are materially easier for residents to fulfil.<sup>368</sup>

However, resident and nonresident taxpayers may be comparable with respect to the income they receive from the source State and the effective tax burden of a nonresident taxpayer shall not generally be higher in the source State than that of a resident taxpayer with respect to that income.<sup>369</sup> As an exception, discriminative taxation in the source State may be allowed, if the taxpayer's State of residence eliminates the effects of the less beneficial taxation in the source State and the elimination is based on an obligation in a tax treaty concluded between the source State and the State of residence.<sup>370</sup> Consequently, the source State must allow also nonresident taxpayers to deduct directly related expenses to the extent that resident taxpayers are entitled to similar deductions, if the gross-basis taxation of nonresidents would lead to a higher tax burden than the net-basis taxation of residents.<sup>371</sup> The nonresident taxpayer may have paid more taxes in the source State than it should have, for example, because it has not been entitled to deduct directly related expenses when the tax was withheld or if no taxes should have been withheld in the first place, for example, because the taxpayer is in a loss-making position or is not subject to tax in general. In such cases, the source State must remedy the situation by refunding the excess tax to the taxpayer.<sup>372</sup> Furthermore, the possible cash-flow disadvantage that nonresidents may face when compared to resident taxpayers does not, in principle, render final withholding taxes inadmissible. Only if the disadvantage is material, i.e. resident taxpayers should pay the tax on a later tax year than nonresident taxpayers, the tax treatment in the source State may be considered precluded by the fundamental freedoms.<sup>373</sup>

Even though final withholding taxes are admissible in principle, the requirements of the EU law have required Member States to make several exceptions to the otherwise simple and straightforward system of generally levying a flat-rate tax on gross dividends. Moreover, the

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<sup>368</sup> Cf. Helminen 2018a, 75.

<sup>369</sup> See e.g. C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, para. 68; C-170/05, *Denkavit*, paras. 34–35; C-379/05, *Amurta*, para. 38; Joined Cases C-10/14, C-14/14 and C-17/14, *Miljoen and Others*, para. 67; C-575/17, *Sofina*, para. 47; Terra & Wattel 2019, 825–826.

<sup>370</sup> See *supra* ch. 2.3.2.2.

<sup>371</sup> See e.g. C-265/04, *Bouanich*, paras. 40–41, 43 and 56; Joined Cases C-10/14, C-14/14 and C-17/14, *Miljoen and Others*, paras. 57–59, 61 and 90; C-18/15, *Brisal*, paras. 23 and 44–47; Terra & Wattel 2019, 826. See similarly Helminen 2010b, 404.

<sup>372</sup> See generally *supra* ch. 3.3.

<sup>373</sup> Cf. C-252/14, *Pensioenfonds Metaal en Techniek*, para. 41; C-575/17, *Sofina*, para. 30; Willems 2019, 103.

judgements of the CJEU in direct tax cases have forced Member States to amend their legislation to be in line with the Treaties every now and then. This is prone to leading to ‘ad hoc’ changes in legislation, which may make the tax legislation concerning cross-border dividend taxation complex.<sup>374</sup> This has increased the administrative burden related to withholding taxes both for the tax authorities and for the taxpayers striving for their rights. Furthermore, if the withholding agent cannot, for whatever reason, levy a ‘correct’<sup>375</sup> amount of taxes but overwithholds instead, the Member State is required to refund the excess taxes to the taxpayer. Such a system, although bringing an outcome that is eventually right and in line with the fundamental freedoms, is manifestly uneconomical and inefficient. The taxpayer may be required, for example, to prove that a comparable taxpayer resident in the source State would not be required to pay taxes in a similar domestic situation and that the taxpayer cannot get full refund of the taxes paid in the source State in his State of residence, and the tax authorities are required to assess the admissibility of the nonresident taxpayer’s application.<sup>376</sup> The next chapter discusses the possibilities to make dividend taxation in cross-border settings more efficient and economical.

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<sup>374</sup> See, for example, the Finnish Act on the Taxation of Income of a Person Subject to Limited Tax Liability (Laki rajoitetusti verovelvollisen tulon verottamisesta 627/1978).

<sup>375</sup> That is, in accordance with the requirements of domestic legislation, tax treaties, and the EU tax law.

<sup>376</sup> See *supra* text accompanying note 278, concerning the Finnish practice for allowing nonresident pension institutions to make similar deductions on their Finnish-source dividend income as domestic pension institutions after the Case C-342/10, *Commission v Finland*.

## 5 Possibilities to Refine the Existing System

### 5.1 Introduction

It is apparent from the CJEU's case law that taxation of outbound dividends with final withholding taxes is not an optimal system from the internal market perspective. Especially due to the widespread use of Collective Investment Vehicles ('CIV'), final withholding taxes are in severe strains.<sup>377</sup> However, if we accept the prevailing principle of allowing the source State to levy tax on portfolio dividends, some method of tax collection must exist.

Solutions achievable with negative integration may at least ostensibly remove the less beneficial treatment of nonresidents in the source State. Therefore, the fundamental freedoms may in many cases ensure that taxpayers receiving cross-border dividends are taxed on net basis.<sup>378</sup> However, the CJEU cannot dictate the process to be applied by the Member States,<sup>379</sup> and the methods adopted by Member States appear not to be truly cost effective for the taxpayers or the tax authorities.<sup>380</sup> Furthermore, as the CJEU is unable to address hindrances caused by tax disparities or the Member States' parallel exercise of taxing power,<sup>381</sup> it is obvious that the impediments caused by source taxation of portfolio dividends cannot be eliminated without proactive measures taken by the Member States or taken at the EU level.<sup>382</sup>

The challenges related to final withholding taxation of cross-border dividends are not unknown to the policymakers, and some initiatives have been presented to simplify the process. Initiatives to make withholding tax procedures more efficient have been taken at the EU level at least since the first few years of the 21<sup>st</sup> century, when the 'Giovannini reports' were published in 2001 and

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<sup>377</sup> CIVs are particularly problematic, as they usually take 'non-traditional' legal forms that may not be commonly identified in other Member States (unlike, for example, corporate entities that are listed in the Parent-Subsidiary Directive), so the comparability of a foreign CIV and a domestic CIV is not usually straightforward. Furthermore, CIVs may be transparent or opaque for tax purposes, they often have multiple beneficiaries and the ownership structures in CIVs are commonly layered. Additionally, investors in a CIV may also be other CIVs, forming a 'fund-of-funds'.

<sup>378</sup> See *supra* ch. 4.2.

<sup>379</sup> For example, in Case C-385/00, *De Groot*, para. 115, the CJEU held that the EU law "contains no specific requirement with regard to the way in which the State of residence must take into account the personal and family circumstances" of a taxpayer. In general, the CJEU cannot prescribe how a prohibited national measure should be replaced. See Terra & Wattel 2019, 48.

<sup>380</sup> Cf. Code of Conduct on WHT 2017, 5–6.

<sup>381</sup> Terra & Wattel 2019, 48.

<sup>382</sup> Due to the unanimity requirement in the area of direct taxation, the difference between 'proactivity of Member States' and 'measures taken at the EU level' is not that large.

2003.<sup>383</sup> These initiatives are based on refining the existing system of withholding taxation. The possibilities brought up by the EU initiatives, most currently a ‘Code of Conduct on Withholding Tax’<sup>384</sup> published in 2017 are discussed below.<sup>385</sup>

## 5.2 Code of Conduct on Withholding Tax

The Commission has initiated steps to simplify the withholding tax relief and refund procedures within the EU as a part of creating “a true single market for capital”<sup>386</sup> in the EU.<sup>387</sup> The EU-led process for simplifying the withholding tax procedures has already been up since the turn of the millennium<sup>388</sup> and it picked up speed after the launch of the Commission’s Action Plan for a Capital Markets Union (‘CMU Action Plan’) in 2015.<sup>389</sup> Although the CMU Action Plan is still ongoing, it has already yielded, *inter alia*, a Code of Conduct on Withholding Tax, published on 11 December 2017.<sup>390</sup> The Code of Conduct on Withholding Tax focus on the streamlining of the withholding tax refund and relief procedures. It builds upon the prevailing method of levying final withholding tax in the source State and the possibility for the taxpayer to claim for refund if tax has been levied in excess, for example, due to incorrect application of a tax treaty or not granting an EU law based benefit.

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<sup>383</sup> The Giovannini Group, chaired by Dr. Alberto Giovannini, was formed in 1996 to advice the Commission on, *inter alia*, financial integration and the efficiency of the financial markets in the EU. The Group published two reports, Cross-Border Clearing and Settlement Arrangements in the European Union in 2001 and Second Report on EU Clearing and Settlement Arrangements in 2003. See Giovannini Group 2001, 1; Giovannini Group 2003, 1.

<sup>384</sup> See Code of Conduct on WHT 2017.

<sup>385</sup> Furthermore, the OECD has addressed the difficulties that CIVs encounter in receiving tax treaty benefits in the Treaty Relief and Compliance Enhancement (‘TRACE’) Project. The TRACE Project focuses on streamlining the procedural aspects of granting tax treaty benefits to portfolio investors investing through a CIV. The TRACE Project shares many similarities with the Code of Conduct on Withholding Tax, but it addresses specifically the issues related to investing through CIVs.

The project had its start in 2006 and culminated – so far – in January 2013, when the OECD Committee on Fiscal Affairs endorsed the TRACE Implementation Package. See <http://www.oecd.org/ctp/exchange-of-tax-information/aboutthetracegroup.htm>. The TRACE Project appears to be dormant, but it has picked up some speed due to the implementation of FATCA and CRS, and to the author’s knowledge, no State has adopted the TRACE to date. See Plowgian, Riccardi & Mueller 2017, 68.

<sup>386</sup> Commission 2015, 3.

<sup>387</sup> *Id.*

<sup>388</sup> See e.g. T-BAG Group Report 2013, 9–13, summarising the earlier work. See also e.g. Commission Recommendation of 19 October 2009 on withholding tax relief procedures (Text with EEA relevance), OJ L 279, 24.10.2009, 8–11.

<sup>389</sup> See Commission 2015.

<sup>390</sup> Code of Conduct on WHT 2017. The Code of Conduct is not formally adopted by Member States. See Code of Conduct on WHT 2017, 4.

The proposed actions for improving the efficiency of the refund process seem practical and sensible. However, they may require investments in IT systems. The simplest proposals include publishing user-friendly, electronic forms that do not require knowledge on the local language or tax administration for claiming refund or applying for relief, and attaching clear guidance to the forms. The guidance and the forms should be “available in addition to the national language in at least one foreign language customary in the sphere of international finance”<sup>391</sup>.<sup>392</sup> Further simple proposals are making the documentation requirements more user-friendly and electronic inasmuch as feasible under the domestic legislation, and setting up a single point of contact.<sup>393</sup> Proposals that may require investing in IT systems generally suggest that Member States would make the IT systems applied in the whole refund and relief procedure efficient and integrated so that the whole reclaim process could be completed easily online. The IT systems should also allow for efficient processing of the reclaims.<sup>394</sup> Lastly, it is suggested that also nonresident taxpayers or their nonresident representatives would be enabled to make reclaims.<sup>395</sup> Furthermore, the Code of Conduct suggests that the withholding agent would be allowed to grant relief at source where that is feasible or practical.<sup>396</sup>

### 5.3 Elaborating the Code of Conduct on Withholding Tax – a Way towards Provisional Withholding Tax in Intra-EU Settings?

The Code of Conduct is not legally binding and not even formally adopted by the Member States.<sup>397</sup> However, the suggestions seem sensible and would, if put in practice, alleviate the most manifest problems of current refund processes, namely the duration and the remarkable administrative burden it causes both to the taxpayers and the tax authorities. In fact, at its best the final withholding tax process could resemble the provisional withholding tax process.

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<sup>391</sup> Code of Conduct on WHT 2017, 9.

<sup>392</sup> Code of Conduct on WHT 2017, 8–9.

<sup>393</sup> Code of Conduct on WHT 2017, 9–10.

<sup>394</sup> Code of Conduct on WHT 2017, 7–8.

<sup>395</sup> Code of Conduct on WHT 2017, 6.

<sup>396</sup> Code of Conduct on WHT 2017, 11.

<sup>397</sup> Code of Conduct on WHT 2017, 4. See also Terra & Wattel 2019, 28–29, discussing that the codes of conduct are political commitments that are not legally binding in general, but may have politically a *de facto* binding effect. However, as Member States have not formally adopted the Code of Conduct, it does not seem even politically ‘binding’ and, thus, serves mostly as a compilation of approaches that could improve the efficiency of current withholding tax procedures. Cf. Code of Conduct on WHT 2017, 4.

In the first place, this would require that relief at source could be applied effectively to eliminate cases where there is no legal uncertainty on the applicable tax rate and levying excess tax is obvious. Such a case could be, for example, the application of tax treaty based tax rates or even accepting an EU law based exemption or reduction at source, if an identical case has already been solved by the CJEU (*acte éclairé*<sup>398</sup> situation). Obviously, the withholding agent would take a huge risk if it was held strictly liable for the tax in case of failure to withhold. Thus, to make the relief at source a feasible option, the liability of the withholding agent should also be mitigated, for example, by providing authorized and binding<sup>399</sup> guidelines of situations, where the withholding agent is entitled to grant relief at source. Alternatively, the taxpayer could be given a possibility to get a decision from tax authorities on the applicable tax rate in advance, which the withholding agent should follow.<sup>400</sup> Materially, this would correspond to the possible pre-withholding adjustments in provisional withholding taxes or to estimating the proper advance payments in advance taxation, with the outcome that the tax would usually be levied in a correct amount right from the outset.

Expanding the use of relief at source would increase the probability of underwithholding and, consequently, loss of tax revenue.<sup>401</sup> In such a situation, the source State could still resort to the recovery assistance procedures to collect the tax from a nonresident taxpayer.<sup>402</sup> The inefficiency of the RAD may, however, decrease the Member States' enthusiasm to increase their dependency on mutual assistance in taxation of nonresidents.<sup>403</sup> Furthermore, the *de minimis* threshold of

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<sup>398</sup> See Vukčević 2012, 656–658.

<sup>399</sup> The withholding agent should be able to rely on the guidelines so that it could not be held liable for inadequate withholding if it had acted in accordance to the guidelines.

<sup>400</sup> Such as the Finnish nonresident's tax at source card. Regarding the Finnish nonresident's tax at source card, see Nykänen 2015, 210.

<sup>401</sup> Clearly, the risk that the withholding agent underwithholds increases, if the withholding agent must consider e.g. what expenses should be deductible on the dividend tax. The withholding agent may make an error or the taxpayer may submit erroneous information either deliberately or unintentionally. For similar reasons, the tax authorities could give an incorrect decision on the applicable withholding tax rate. If the withholding agent were not held strictly liable for the tax amount – as it should not be in order to encourage it to grant relief at source – the source State would be compelled to reclaim taxes from abroad in order to avoid loss of tax revenue, if the withholding agent had failed to levy a proper amount of taxes.

<sup>402</sup> See *supra* ch. 2.3.3.3.

<sup>403</sup> *Id.*



EUR 1,500<sup>404</sup> practically precludes Member States from resorting to the RAD with regard to small dividends.<sup>405</sup>

In the second place, a practicable and decently quick refund procedure for overwithheld taxes would alleviate the presently burdensome and lengthy refund procedure. According to a Commission report, the costs of compliance and complexity of the refund procedure may prevent retail investors from making refund claims, whereas substantial administrative expenditure is inflicted on institutional investors.<sup>406</sup> Furthermore, the duration of the refund process precludes the taxpayer from using the money for some other purposes, i.e. causes high opportunity costs.<sup>407</sup> It may also incur cash-flow disadvantage to nonresident taxpayers, supposing that nonresident taxpayers are more likely to be subject to a time-consuming refund procedure than resident taxpayers.<sup>408</sup> The proposed actions presented in the Code of Conduct for streamlining the refund procedure appear to be capable of reducing the administrative burden and expenditure related to claiming refund for overwithheld taxes both for tax authorities and taxpayers.<sup>409</sup> Speeding up the refund procedure would also mitigate the cash-flow disadvantage arising in cases of overwithholding, whereas the possibility for relief at source would prevent any cash-flow disadvantage from taking place.

The strength and simultaneously the weakness of the Code of Conduct based approach is that it builds upon the existing system, which is based on the application of different rules on resident and nonresident taxpayers in the source State. Member States could put the proposed actions in practice by themselves, therefore eliminating the need of positive harmonisation of direct taxation.<sup>410</sup> However, it does not mitigate impediments to the fundamental freedoms that are caused by non-discriminative tax disparities, i.e. differences in tax laws and administrative processes of Member States.<sup>411</sup> Furthermore, it cannot provide solutions to ease the cumbersome

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<sup>404</sup> Art. 18(3) RAD.

<sup>405</sup> Member States could overcome the challenges related to the *de minimis* threshold by applying final withholding on dividends not exceeding a certain limit. For example in Luxembourg, final withholding is applied also in domestic settings on individual dividend recipients, if the annual amount of dividends does not exceed EUR 1,500, yet exceptions apply to this rule. See Adam & Lyaudet 2018, 412.

<sup>406</sup> Commission 2017a, 10.

<sup>407</sup> Code of Conduct on WHT 2017, 8; Commission 2017a, 11.

<sup>408</sup> See *supra* ch. 3.2.5.

<sup>409</sup> With regard to the proposed actions, see *supra* ch. 5.2.

<sup>410</sup> Positive harmonisation in the field of direct taxation requires unanimity of the Member States, which has been difficult to attain. See Terra & Wattel 2019, 46.

<sup>411</sup> Cf. Helminen 2018a, 68–69; Terra & Wattel 2019, 47–48.

process of claiming EU law based relief either, with the possible exception of *acte éclairé* situations.

## 6 Conclusions

The purpose of this study was to evaluate the benefits and disadvantages of final withholding taxes for taxation of portfolio dividends in the source State in intra-EU situations. It appeared that from the administrative point of view, final withholding taxation of portfolio dividends is beneficial both for the nonresident taxpayer and the source State. It is an easy form of tax collection for the nonresident taxpayer, where the taxpayer does not need to be familiar with the tax laws and administrative procedures of the source State. The withholding agent calculates and pays the final tax to the source State on behalf of the taxpayer. At best, the involvement of the taxpayer is not needed at all. For example, the taxpayer does not need to file a tax return or submit excessive information to the tax authorities or to the withholding agent. Consequently, no material costs of compliance incur to the taxpayer. For the source State, final withholding taxes ensure the effective collection of taxes without the need to resort to the mutual assistance mechanisms. Above all, final withholding taxes are highly administrable at best, with low costs of tax collection.<sup>412</sup>

However, final withholding taxes are difficult to levy on any other than gross income. Therefore, the taxpayer's ability to pay taxes cannot be properly regarded.<sup>413</sup> In general, this reduces the equity between nonresident taxpayers, because taxpayers with low expenses may be taxed short of their ability to pay taxes, whereas taxpayers with high expenses may be taxed in excess of their ability to pay taxes. In particular, final withholding taxes would be levied even if the taxpayer's expenses exceed the income. By contrast, in domestic settings, Member States typically try to follow the ability-to-pay principle. Therefore, resident taxpayers may usually deduct business expenses and different personal expenses.<sup>414</sup>

According to the case law of the CJEU, the source State may not treat nonresident taxpayers less beneficially than resident taxpayers, if they are held comparable.<sup>415</sup> Although resident and nonresident taxpayers are not comparable in principle, they become comparable, once the source State imposes tax liability to the resident and nonresident taxpayers alike. The CJEU has also held that the source State may apply final withholding taxes on taxation of portfolio dividends received

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<sup>412</sup> See *supra* the discussion and references in ch. 3.2.

<sup>413</sup> See *supra* the discussion and references in ch. 3.2.4.

<sup>414</sup> See *supra* the discussion and references in ch. 2.1 and ch. 3.

<sup>415</sup> Less beneficial treatment in the source State may be allowed, if the State of residence of the taxpayer is obliged, under a tax treaty concluded by the State of residence and the source State, to eliminate the less beneficial treatment of the source State and it also effectively does so.

by nonresident taxpayers, even if some other taxation method is applied on resident taxpayers. However, the different taxation method may not lead to the disadvantage of nonresident taxpayers. Less beneficial treatment, especially differences in the final tax amount and material differences in the time of tax payment, cannot be justified with effective collection of taxes and fiscal supervision, because the RAD and the DAC provides Member States with less restrictive means for achieving the same objectives. Consequently, the CJEU has held that the source State shall not levy tax on portfolio dividends received by a nonresident taxpayer, if it did not levy taxes from a comparable resident taxpayer. The source State must also allow nonresident taxpayers to deduct expenses that are directly related to generating the income in the source State, if the source State allows its residents to deduct similar expenses. In general, the source State may not levy more taxes from a nonresident taxpayer than it would levy from a comparable resident taxpayer on the same income.<sup>416</sup> Furthermore, the source State must allow the nonresident taxpayer to defer the payment of tax on the same conditions as it would allow the deferral to a comparable resident taxpayer.<sup>417</sup>

What follows from the CJEU's case law is, firstly, that the differences in the taxation of resident and nonresident taxpayers in the source State are reduced. Secondly, the nonresident taxpayer is often required to resort to the refund procedure before it receives as beneficial a treatment as it should under the fundamental freedoms. The refund procedure, then, eliminates most of the benefits of final withholding taxes: it is a lengthy and expensive procedure, and the nonresident taxpayer is most likely required to resort to external help. The findings made in chapter 5 on the possibilities to apply relief at source and streamlining the refund procedure would alleviate the problems that currently plague the refund procedure. However, it would not fix the fundamental problem faced by investors active in the internal market. To their detriment, there is no single 'European' approach to taxation of cross-border portfolio dividends in the internal market. Quite the contrary, the tax treatment is affected by the domestic tax laws of 28 fiscally sovereign Member States together with their tax treaty networks, with the limits set by the fundamental freedoms looming ambiguously over them.

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<sup>416</sup> However, the source State does not need to allow the deduction of the person-related expenses of the nonresident taxpayer.

<sup>417</sup> See *supra* the discussion and references in ch. 4.2.

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C-382/16, *Hornbach-Baumarkt*, opinion of AG Bobek

**EFTA Court**

E-1/04, *Fokus Bank ASA*